H.R. 3153, THE HOME EQUITY PROTECTION ACT OF 1993

HEARING

BEFORE THE

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

MARCH 22, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

Serial No. 103–127

U.S. GOVERNMENT PRINTING OFFICE

77–606 CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-046631-8

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TUESDAY, MARCH 22, 1994

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:57 a.m., in room 2322, Rayburn House Office Building, Hon. Joseph Kennedy, [chairman of the subcommittee] presiding.

Present: Chairman Kennedy, Representatives Roybal-Allard, Furse, Velazquez, Wynn, Watt, Maloney, Deutsch, McCandless, King, Pryce, Bereuter, and Lazio.

Chairman KENNEDY. The subcommittee will please come to order.

I, first of all, want to apologize to all of the members, witnesses, and members of the audience. I was testifying downstairs at a hearing on child sexual prostitution and the chairman of the committee and the other members kept asking questions. So I apologize, but I couldn't get up and leave.

This morning, this subcommittee holds its second hearing on the serious problem of home lending abuse. This is a problem that is national in scope. It affects people of all backgrounds, white and black, urban and rural. Tens of thousands of hard-working families have become unwitting victims of scam artists and predatory lenders. They have worked their entire lives to finally own their own homes, only to lose them to unscrupulous lenders hellbent on exploiting their age or lack of financial know-how. In many cases, they have lost their savings, their homes, and the peace of mind that they earned through years of sweat and toil.

The subcommittee, as well as the Senate Banking Committee, has collected overwhelming evidence of shocking abuses taking place throughout the country. We have seen consumers paying 20, 30, even 40 percent on home equity loans. We have seen consumers who are squeezed into paying 25 percent or more of a loan just in fees and costs. And we have seen consumers lose their homes due to the hidden terms of a loan that are the hallmarks of these mortgage scams: Balloon payments, negative amortization, and prepayment penalties.

Our first witness today, Marge Robins, who lives just a couple of blocks away from me in Brighton, Massachusetts, is one of the thousands of homeowners in my State who became trapped in a spiral of debt by unscrupulous loan sharks. Ms. Robins, we welcome you here today, and thank you for coming.

At one point, she was supporting her disabled and now, I am sorry to say, deceased husband as well as her developmentally disabled son on an income of $2,563 a month, paying $2,150 of that amount for a home equity loan. That is about 84 percent of her income. And if that isn't loan shark underwriting, then I don't know what is.

All told, she was forced to refinance 11 times, each time paying thousands of dollars in prepayment penalties, broker fees, and other outrageously inflated costs.

H.R. 3153, the Home Equity Protection Act, was introduced to make sure that what happened to Marge Robins does not happen again to any American homeowner. Its goal is simple: To curb the abuses in the home equity market without curbing the ability of that market to provide valuable refinancing and financing options to consumers.

Since introduction, I've consulted with members of both sides of the aisle, and I have also heard from several responsible industry members who acknowledge that abuses in the market must be stopped. A number of constructive suggestions have been put forward which I believe will improve the bill's ability to meet its goal. It is my intention to offer these suggestions in an amendment when the subcommittee marks up this legislation.

I particularly want to thank Chairman Flake, Mr. LaRocco, Mr. Fields, Mr. Watt, Ms. Furse, Ms. Roybal-Allard, and Mr. King for their input. I also want to recognize the constructive role played by Household International, Beneficial Management, Fleet Finance, and the AARP. These organizations have all written in support of H.R. 3153, as I would hope to amend it. Copies of their letters are on each members' desk. I would also ask unanimous consent that these letters be made part of the record.

[The letters referred to can be found in the appendix.]

These changes will not erode the fundamental consumer protections of the bill. On these there can be no compromise. First and foremost, consumers must get full disclosure of the risks of high-cost home equity loans, including notice that they could lose their home and might be able to find a cheaper loan.

Second, the bill prohibits lenders from taking advantage of a consumer's age, lack of financial know-how, or physical and mental infirmities.

Third, the bill assigns liability for those loans to the mainstream lenders who often buy them. Under this provision, these lenders will no longer be able to wash their hands of the fraud and deceit used by brokers or finance companies who make the loan in the first place.

Finally, where consumers are paying more than 50 percent of their i[illegible]ome for a high-cost loan, the bill outlaws the practices that are mo[illegible] of[illegible]n used to rob people of their money and their homes. The [illegible]ices include balloon payments, negative amortization, pre[illegible] penalties, and refinancings at higher rates. I am hopeful [illegible] changes we can bring a well-balanced bill to con[illegible] Senate. It is critical that we act now to stop the mo[illegible]that have turned the American dream of home ow[illegible]tmare for tens of thousands of families.

I again apologize to all of the members and the witnesses in the audience for being late, and I recognize Mr. McCandless for an opening statement.

[The prepared statement of Chairman Kennedy can be found in the appendix.]

Mr. McCandless. Thank you, Mr. Chairman. I want to thank you for holding this hearing this morning on H.R. 3153 instead of moving directly to mark up, especially considering your bill was not yet introduced when the subcommittee held a hearing on the issue of reverse redlining over a year ago.

I am encouraged that you are holding a hearing this morning, and that you have indicated that you will make several helpful changes to the bill.

I must admit that I still have several reservations regarding the legislation. First, I am concerned with whether this bill is really necessary considering the laws that are already on the books.

For example, the Real Estate Settlement Procedures Act as amended by the Housing and Community Development Act of 1992, now covers second mortgage loans as well as first mortgage loans, and will soon require mortgage brokers to make many of the same disclosures that would be required under this bill.

Further, many States, including California, already have sophisticated statutes to protect borrowers.

Second, I am concerned that some of the financing mechanisms that this bill would prohibit might actually perpetuate the credit crunch. We must be careful not to inadvertently constrict the availability of credit in our zeal to stamp out predatory lending practices.

Third, I am concerned with some of the bill's provisions which could spark litigation if not adequately clarified. Our objective should be to eliminate reverse redlining, not to threaten legitimate lenders with vague legal liability.

I take your time to mention my reservations in the hope that our witnesses will be able to address them in their comments this morning.

Thank you, Mr. Chairman.

Chairman Kennedy. Thank you, Mr. McCandless. Mr. Watt.

Mr. Watt. Mr. Chairman, in light of the lateness of the start of the hearing, I will forego any opening statement.

Chairman Kennedy. Thank you very much, Mr. Watt.

Mr. Bereuter.

Mr. Bereuter. Mr. Chairman, I will also forego and look forward to the testimony.

Chairman Kennedy. Thank you very much. Mr. Wynn.

Mr. Wynn. Thank you, Mr. Chairman, I will also forego an opening statement at this time. I would like to reserve the right to submit it.

Chairman Kennedy. Without objection, so ordered.

Mr. King.

Mr. King. Mr. Chairman, I want to commend you for holding the hearing and like the other members I look forward to the testimony.

Chairman Kennedy. Thank you very much. Ms. Roybal-Allard.

Ms. ROYBAL-ALLARD. I request unanimous consent to submit my comments for the record.

Chairman KENNEDY. Thank you very much. Without objection, so ordered.

[The prepared statement of Lucille Roybal-Allard can be found in the appendix.]

Chairman KENNEDY. And Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. I also would forego and welcome the witnesses as they testify before us.

Chairman KENNEDY. Thank you very much. Ms. Velazquez.

Ms. VELAZQUEZ. I ask unanimous consent to submit my testimony.

Chairman KENNEDY. Thank you very much. Without objection, it is so ordered.

[The prepared statement of Nydia Velazquez can be found in the appendix.]

Chairman KENNEDY. With that, I want to thank the members of the panel for their opening statements and we look forward to directly hearing from our witnesses.

Our first panel of witnesses has already been seated at the table. We want to thank you for being here this morning.

Your entire written statements will be submitted for the record, so I would ask you to limit your oral statements to 5 minutes and to summarize your testimony in the interest of time.

Marjorie Robins is a resident of Brighton, Massachusetts. In 1984 she received a loan for $37,500 to make home repairs. This loan was refinanced 11 times and mushroomed to $161,000 in 1992. At one point during this time her loan payment exceeded her monthly income.

Ms. Robins, I know this is a difficult story for you to tell. We very much appreciate your willingness to share your story with us to try to protect others so that they don't fall into the same kind of circumstances that you found yourself.

The reality is that what happened to you has happened to thousands of other people across our country even in our own hometown. Therefore, we need to enact this legislation and your testimony is critical to bringing home the importance of these protections, so we thank you and we wish you to go ahead and make your oral statement.

STATEMENT OF MARJORIE ROBINS, A RESIDENT OF BRIGHTON, MA

] i. ROBINS. Thank you, Mr. Kennedy, and I also believe that y ed this legislation because I wouldn't want anybody to go thr gh what I went through. It was a terrible, terrible experience.

(rman KENNEDY. Ms. Robins, could you pull that microphone] it (se to you?

i. .)BINS. It was a terrible, terrible experience and I wouldn't ıyone else to have to go through what I went through. I lost ıole life. I lost my husband. I lost my house and I had to buy and I will tell you from the start what happened.

ı ıı in B on. I am one of your constituents. I live there with ! ar-o relopmentally disabled son. He lives on the third ııoor ı apartment up there.

He helps with the mortgage. He gets a disability check and he also works part time and brings in a small amount of money, which in turn helps to pay the mortgage.

I work part time for the Boston School Department in a cafeteria. I had to cut down my hours because my husband was sick and I was sick also. I only make $164 a week—that's before taxes—and before my husband took sick, my husband, Gary, was a self-employed cabdriver who leased a cab until he had part of his foot amputated and prior to his illness he made between $150 a day working 12–14 hours a day in order to pay this.

We also get rental income of approximately $800 a month for my first-floor apartment plus a Social Security check for a total income of $2,563 a month, less than half of what we got, as you said, before my Gary took sick and passed away.

We paid off the original mortgage in 1983. We originally purchased our home in 1966 for $28,500. We refinanced a small amount remaining balance that we had. In 1983 we had 5 years left to go on our mortgage and we had to refinance because the city of Boston's Inspectional Service Department had cited us and wanted us to do repairs on the house to bring it up to housing code.

My brother-in-law, who had a mortgage with Financial Enterprises, told us about Financial Enterprises and introduced us to the gentleman who was the, he was the president and he since has become the vice president, and the first loan we got from them was in 1983. You said 1984 but it was in 1983. We paid off our mortgage, first mortgage, and borrowed $37,500 at a rate of more than 16.5 percent and they began to call us repeatedly and keep asking us after I had this loan to refinance.

During the course of the years we refinanced 11 times to put up new storm windows, fix porches, gutters, roof, painted, caught up on back taxes which we fell behind because of the big payments, caught up on excessive water bills and medical bills. Along with my husband being sick, my son was born with many medical problems and he had five operations and we had to back those and were being done by Children's Hospital of Boston and Doctors and we borrowed money to pay out because we had no Blue Cross at that time. We couldn't afford to pay it.

No one ever told us that each time we refinanced they were charging us the penalty to pay off the old loan. We also did not see that they were charging attorney fees of many thousand dollars through the refinancing. We found out later that these attorney fees were going to the president of the company. I mentioned his name before. He was the company attorney.

In June 1990, we also found out, I found out by accident that Financial Enterprises had us sign a refinancing agreement including a quick claim deed in Financial Enterprises' name, which meant that we did not own the house, that Financial Enterprises owned the house and the only way we could get it back was to pay off the entire mortgage.

My husband almost went out of his mind when he heard this and we tried to refinance. At this point we were having a hard time making the payments. I think the payments were $1,900. We were still having a hard time, and I never realized it, with the prepenalty clause until one day I came home from work and my

Ms. ROBINS. We were told of another organization, the Victim Resolution Program, run by the bankers of Massachusetts but they turned us down flat too because they didn't want to deal with an out-of-State bank.

They referred us to Norma Moseley, an angel. She is head of the Ecumenical Social Action Committee in Boston, who took us in hand. Norma had me contact a lawyer who also has since been disbarred, a Donald Brown, who contacted Advanta Mortgage and threatened them with a lawsuit, a 51(a) or something like that. More legal fees, though, and more money involved.

I had to scrape together $3,000 or more to send to—I don't remember the exact figure because by this time I was, we had no savings and I had to scrape and scribble the money together and this held off a foreclosure for 2 more months to come up with some sort of plan.

We didn't know what we were going to do. That is when Norma and her staff went to work. They contacted the Shawmut Bank of Boston, who had the house reappraised—I'll remind you we had just had the house reappraised 2 years ago—and the appraisal we had received in September 1990 was $302,000. When the appraisal was done again by the Shawmut Bank, it had gone down to $200,000.

The city had another appraisal for tax purposes which was higher than the appraisal of the Shawmut Bank so I actually was paying taxes on $269,000 and the bank said my house was only worth $200,000.

When all was finally realized, it would take a minimum of $161,000 to buy back my house, which was sold while we were sitting on the front porch watching Colonial Bank's lawyer, sitting downstairs in his Mercedes Benz all by himself, saying that my house had been sold, the mortgage had been foreclosed. He even had the nerve to call me on the telephone and tell me that my house had been sold, that he had had an auction. There was no one there except him.

Sitting here, writing this, I just hope that what I say today will prevent this from happening to anybody else. My husband and I felt deserted. Shawmut Bank refinanced our mortgage, buying back our house for $161,000, paying my back taxes which came to a considerable amount, gas bills, water bills—I had a $3,000 electric bill because I couldn't pay it because I had put all money into lawyers' fees, bankruptcy fees, scraping money together to foreclose a mortgage which I never got back during the 2-year fight we had to hold onto our house.

I thank God for people like Norma Moseley, Kathleen Keest, and the other people at ESAC. We now have a mortgage of, it's still high, of $1,317 a month, but it includes the principal, interest, and taxes.

The toll it took on me was indescribable. We signed this mortgage in October 1992, but my husband couldn't go on anymore. He took very sick and he went into a coma in December and he was in a coma from December until May and he died in May 1993.

I just hope that my story will help and it won't happen to anybody else again. That's all I can say.

I am very sorry for breaking down. It is a very emotional time for me.

[The prepared statement of Marjorie Robins can be found in the appendix.]

Chairman KENNEDY. Ms. Robins, please. That is as moving a statement as I think I've heard. I guess as my grandmother would say, "With what you have gone through, you could probably get more souls out of purgatory than just about anybody in this room." If you get a chance, you say a prayer for me because you could probably do more for us than just about anybody.

I do appreciate your willingness to come and share your story with us. I know it is very hard to do.

Ms. ROBINS. Thank you.

Chairman KENNEDY. But it is a really important thing that you have done today. I can assure you, as I am sure other members of this subcommittee can, that we will do our best to make sure that what happened to you does not happen to others.

I know Norma well. She is a good person. She is a caring person. I am glad that you found her and that she has been able to provide you with some help and assistance.

It sounds like you still have a lot of money that you are paying out every month, but it sounds like at least you are on a track where you can begin to see a little light of day.

Ms. ROBINS. I manage. But it is hard.

Chairman KENNEDY. I am sure it is, ma'am.

Well, if we can help you out with your fuel bills or any other issues that you are dealing with, you give my office a call and we will try to help you. All right.

Ms. ROBINS. Thank you, very much. Thank you for allowing me to testify.

Chairman KENNEDY. Thank you, very much.

I want to take this time to acknowledge the fact that a group of 50 other victims like Ms. Robins have joined with us. Their ministers are here. Some of their elected officials are attending our hearing this morning.

This group, the Citizens Addressing Public Services, was founded last year by a minister in Augusta, Georgia, the Reverend Minnie Davis, who became concerned when members of her congregation lost their homes to lending companies.

The group rode the bus all night up from Georgia to make their presence felt at this hearing this morning. I want to read a quote from Reverend Davis. It says, "I know these rooms are easily filled with high-priced lawyers doing the work of money lenders," said Reverend Davis. "It is time members of the Congress see the folks who are hurt by these big banks and finance companies."

Well, Reverend Davis, I want to ask you and your group to please stand up. We want to give you a little round of applause here today. [Applause.]

Thank you again, Reverend.

Our next witness is Kathleen Keest who is a staff attorney with the National Consumer Law Center, which is a nonprofit organization representing the interest of low-income consumers.

Ms. Keest specializes in Federal and State credit regulation. Ms. Keest, I know that I speak for all of us when we say that we are looking forward to your testimony. Please proceed for 5 minutes.

STATEMENT OF KATHLEEN KEEST, STAFF ATTORNEY, NATIONAL CONSUMER LAW CENTER, BOSTON, MA

Ms. KEEST. Thank you, Congressman.

I wanted to start out by saying that since we work with attorneys all over the country, we are in a position to tell you that Ms. Robins story is not the only one out there, and Massachusetts is not the only State out there from which these stories come. Massachusetts and Georgia are not the only States out there from which these stories come.

These stories come from California with all of its sophisticated consumer protection legislation that you mentioned. To our testimony, we have appended an example of one really gross loan of a mere $7,500 which had 21 points, and then the equivalent of another 21 points added on in charges, which really made the effective rate of this loan a 30-percent loan.

They come from virtually every jurisdiction except Texas, which is the only State which really tightly limits nonpurchase home mortgages. Consequently, Texas is about the only place that we haven't seen these problems from.

I want to make it clear that you should not be concerned about a credit crunch because we are not talking about legitimate lending here. I had the privilege of serving on some committees with some bankers, including James Fletcher, who is a nationally known and nationally respected lender.

I remember one day when these things were in the press. He came in and he said, "This isn't credit. This is theft." That is what we are trying to stop here, not stopping legitimate lenders. That is what Eugene Ludwig says as well.

By way of background, I want to make a couple of points which at first might seem contradictory, but they aren't really. First is that since 1980 and deregulation, foreclosure rates have gone up about 200 percent. These kinds of loans—being foreclosed directly or forcing other people's first mortgages into default are no small part of that reason.

Second, despite the fact of that increase in the foreclosure rates, these loans are still virtually no-risk credit. Ms. Robins—her lowest appraisal was $200,000. That was the lowest time, and at points I think it was up to $300,000. But the highest loan was only about $113,000 at 20 percent interest. These are no-risk loans.

One of the things that I think it is very important for us to remember is that the majority of these loans are paid and that even when there is foreclosure, these loans were built up from $30,000 to $130,000, with far more smoke and mirrors than they were with real investment that the lender loses.

I want to point out first that there are about three myths that I think we need to get out of the way, things that we hear in opposition to this bill. "One is the borrower has got the money." That t nec ily true because these lenders are alchemists, it is n s.

Second, they signed the papers. They must take the responsibility. It is not that simple. Third, "they are risky loans. There is no other credit available, so they are doing a service."

Last night I heard a news report saying that John Major had had a meeting with Ian Paisley and he was forced to say "Rubbish." That is sort of what I feel about that argument as well.

I just met Ms. Robins for the first time this morning so I haven't had a chance to look at her papers. But I can tell you we are familiar with this particular company. Exhibit 4 gives you an example of the way that this lender worked: Flipping a loan seven times in 3 years with an individual, where through the imposition of prepayment penalties and new charges, those loans, none of which were groater than 18 percent, actually yielded an effective 38 percent loan.

I would love to have the opportunity to look at Ms. Robins loans and show you how much money she got and to see how much of that mortgage that she is paying was smoke and mirrors.

We did a handout early today called "Would you Buy a Used Loan From This Person?" which just takes this California loan actually, that we used, to show how these fees burgeon.

I am not going to walk you through it, but I urge you to look at the arithmetic to see how, for no increase in money the borrowers can end up with a loan principal upon refinancing or foreclosure or whatever that is twice as much as it should have been simply because of the smoke and mirrors.

The primary thing that I think it is important for you to remember is through the points, through the bogus and outrageously inflated fees, through brokers fees, through credit insurance premiums—all of these things—then the 20 percent interest on this grossly inflated principal—that's how these loans grow with smoke and mirrors. That's how these guys operate as alchemists.

The result is a huge lien on these homes without any real investment of their own at risk, or with very little.

As far as the second argument about taking responsibility, I think at a time—if you see these loans, they are 40 pages and only 2 or 3 of those are the legally required, the government-mandated disclosures. They are the only ones with any information on them.

On top of that, we have a recent survey that indicated that 40 percent of adult Americans are functionally illiterate, which should make us stop and question the usefulness of relying on disclosures only.

Then 72 percent of the people in a recent survey that the Consumer Federation of America did, could tell you what the letters "APR" stood for, but only half of them understood what it meant.

Add to that the fact that many of these loans, if not most, are targeted at the most vulnerable people. We had one person, one attorney, that we worked with who surveyed the records in one county of one of the high-rate lenders there; 60 percent of the clients were African-American and 100 percent were elderly.

I think these things are what you have to keep in mind.

I wanted to say a few things about three or four of the most important parts of these bills, one of which is that RESPA does n

These systems have also enabled us to significantly lower our costs of doing business.

This capability has helped us seek out new unserved credit customers. In 1992, we began an effort to specifically target the first and second generation Hispanic population. We began this effort in Texas and California. Because of the success of the program, we have expanded our presence in those States and moved into Illinois as well.

This year, we plan to expand our focus to the top 25 branch offices found within the densest concentration of Hispanic populations.

Last year as part of a planned return to the inner cities, we opened an office in the riot-affected area of Los Angeles. We have been amazed at the response. This branch is growing faster than our typical suburban units and the quality of our customers is on a par with suburban credits.

Our second inner-city office will open in South Jamaica, New York, very soon and three more will open this year. The Hispanic offices and the inner-city branches are managed, staffed, and supported by HFC personnel of ethnic and cultural affinity to the people that they serve. We strongly believe that this is the secret of their success.

Now, I want to make clear that we are not doing this out of altruism. We are doing this because, now that our costs are in line, there are profits to be made in servicing these markets.

Our experience in these offices and our other offices serving blue-collar communities of America is what brings us here today. We share the horror of the subcommittee over the abuses that were uncovered in Georgia and elsewhere. We, of course, would have hoped that market forces would have prevailed to protect the vulnerable individuals cited throughout these and your earlier hearings. But they did not. And we recognize that Congress, and this subcommittee in particular, was forced to act.

We are satisfied that you propose to act temperately and in a fashion which will not have the effect of reducing access to credit for those you wish to protect. You have targeted the areas of abuse and that is wise. You have decided to focus upon disclosure rather than restriction and prescription and that is prudent. You have held the end lender accountable, so long as he is not himself defrauded, for due diligence in what he buys and that is not unreasonable.

Mr. Chairman, by these actions you have demonstrated that you wish not only to eliminate abuse but also to allow and encourage the market to provide credit access to those who need it. In that vein and within that tight framework, we support your effort.

Thank you.

[The prepared statement of Robert E. Elliott can be found in the appendix.]

Chairman KENNEDY. Thank you very much, Mr. Elliott. And I am sure glad th[illegible] I didn't gavel you down. I just wanted to make sure all of you [illegible]ard that. Proposal to act temperately, prudently. I thought he [illegible] it right there. Big Al, what do you think?

Mr. MCCAND[illegible]. Are you from Massachusetts?

Mr. EL[illegible]ir. [Laughter.]

Although I once passed through there.

Chairman KENNEDY. We would welcome him.

Our final witness is going to be introduced by Mr. Peter King. Peter.

Mr. KING. Thank you, Mr. Chairman.

Mr. Chairman, Harry Kutner is a long-time friend of mine. As a matter of fact, he and I worked in the same law office over 20 years ago. He is today one of the leading attorneys in Long Island and New York. His father is a very respected member of the New York State Supreme Court.

He does a tremendous amount of pro bono work, he is active in Catholic Charities matters, he works with the poor and the impoverished. And on this issue, Mr. Chairman, I have to say he is with you and he is very seriously an outstanding lawyer and a very dedicated person. I am very delighted to welcome Harry Kutner to the subcommittee.

Chairman KENNEDY. Terrific. Thank you.

We look forward to your testimony, Mr. Kutner.

STATEMENT OF HARRY KUTNER, ESQUIRE, OF MINEOLA, NY

Mr. KUTNER. Mr. Chairman, Mr. McCandless, other members of the subcommittee, thank you, Mr. King, for the kind words. I am a lawyer, I am not disbarred and I am not a crook, I hope. Thank God—it is unfortunate for the attorneys in general that so few get so much publicity. But there are many, many attorneys out there who do a tremendous amount of work for people the way it was supposed to be done and that's in an unsung fashion.

Unfortunately, Ms. Robins's story is not shocking to me and not shocking to anyone in the field. It touches every congressional district in this country, possibly except for Texas, as Ms. Keest related.

I have been in touch with many, many attorneys since I first came into this a number of years ago. And, unfortunately, it is not limited by race or background; it is more or less limited to economic and socioeconomic factors.

You find that a certain type of individual, home improvement contractor, not content with the good old-fashioned American work ethic, decides to get rich quick and therein lies the beginning of the end for all of these homeowners. They quickly find birds of their own feather and unscrupulous financiers who have the ear of either legitimate banks through illegitimate means, such as commercial bribery, or unwittingly duped banks. But the banks also are there to be duped because they don't ask questions that should be asked.

What I would like to address my oral remarks to—I have submitted the written remarks, unfortunately, in the wrong fashion, because I have had no experience in this field. I thought it was supposed to be in the third person.

But what I would like to submit to you is that the concerns of Mr. McCandless and other members who might have some reservations about the bill I believe are misplaced. As Mr. Elliott showed, it would not hamper commerce because these loans that are sought to be prohibited are loans which should not be made. And either the investors of the individual banks or the taxpayers in the United States end up picking up the tab.

Bank Atlantic down in Florida was heavily involved in the class action, which I am helping to prosecute. They were tapped for the tune of $50 million. That's $50 million, by an unscrupulous financier up in Long Island who is now into his third incarnation. He started out as Northeast Credit—Northeast Holding Corp. The family name is Beyer, B-e-y-e-r. And, as an example, I have a set of loan documents which, before he refined the scam, show that they are all signed in blank. So the concerns that the disclosures are already covered by existing legislation is and is not true.

To a certain extent, these individuals will get around some of the laws that you pass no matter what you do by duping the innocent homeowner. But if you put an incentive or a disincentive in there for the legitimate bank to take the loans that they should not be buying for—because of the uncreditworthiness of the individuals, then at least you are starting to curtail the practice, and that's where the secret lies.

Here you have the disincentives such as the eliminator of holder in due course status. We faced that defense in our class action, although it won't hold because we have information from the Secret Service and the U.S. Attorney's Office in Fort Lauderdale that a bank loan officer at Bank Atlantic at least was compromised.

But if a legitimate banker sees a loan which is running, in our cases, between 19.88 and 24 percent when the market rate is 12 percent, which to anybody who has any familiarity with home improvements is extremely exhorbitantly overpriced, the flag should go up, bells should go off. Why do people need loans which require negative amortization, exhorbitant interest rates, and balloon payments? It's because they can't get legitimate credit elsewhere.

And the reason it seems that they can't get legitimate credit is because they are bad credit risks. That's where the scam lies. What they do is they chop the loan and the illegitimate spread between the market rate and the actual rate that the loan is made at does not go to the banker to cover the increased risk of making a loan to somebody who might otherwise be uncreditworthy. What is done is it is divvied up by all of the pirates, the home improvement contractors, the unscrupulous financier, and the possible compromised bank official. They divvy it up. It is called in their parlance "the chop," and that word is in—is a word of art among these people.

They chop the loan and they discount it according to the difficulty in getting some bank to buy the loan eventually. The way they do it is they bring in such as a Mrs. Berger. Mrs. Berger was older than Mrs. Robins. She was blind, diabetically crippled, and confined to a wheelchair. The lady was, in a true spirit of ecumenism, serviced by Catholic Charities. She was a Southern Baptist a [illegible] a Jewish lawyer brought her to me.

W [illegible] together and, because of my background and one t [illegible] e [illegible] ing a home improvement contractor who went from [illegible] sinessman to going into this scheme and de- [illegible]. I believe [illegible] ne and the Beyers were the ones who initially [illegible] this [illegible] in the late seventies and early eighties and it [illegible] acr[illegible] the country.

[illegible] ting him. And I was able to tell these individ[illegible] [illegible] dn't realize such as a $5,800 contract price

which already was probably 50 percent exhorbitant was changed by adding a 1 after they left the home to $15,800.

The fact that they charged Mrs. Berger, who couldn't get around except in a wheelchair, $9,350 to put a 10 by 12 deck on the outside of her house that is inaccessible from the interior of the home. You have to go down four front steps, around a dirt yard, and up four more steps to get onto this deck. The deck doesn't even have concrete footings. It was whipped up in about 4 to 5 hours by four or five workmen. Even lawyers wouldn't put up decks that way, Mr. Kennedy.

Mr. Beyer, in developing this scheme then changed the name from Northeastern Holding Corp., back in the late seventies and early eighties where they preyed primarily on people in South Jamaica, to Sterling Resources and tried to spiff up their image by taking a spiffy name. And had, instead of individual forms which were not tied together, had a packet. And this enhanced the fraud. Because what they did is the home improvement contractor would just drop this in front of the Mrs. Bergers of the world, whip through it, and have them sign and tell them it was just a credit application. And they'd say, Mrs. Berger, if we can get your credit approved, you're eligible for the Federal program. This was the common scam. We've had two salesmen explain it to us who have had to have their identities concealed.

The Federal program starts to ring sometimes in some communities. And they were told that there was money out there, Federal money to make available to these people 2 percent interest rate. And that thereby by combining the existing mortgage, possibly some credit card debt, maybe a couple of car loans, or other existing debt, their new payment would be less than the existing payment.

Unfortunately, for Mrs. Berger, she ended up with paying 73 percent of her monthly income, $1,031.12 out of a montly pension, black miner's lung pension, of $1,812, on which she had to support a retarded granddaughter and brain-damaged great-granddaughter on a measley $480 a month. She had to pay the highest utility rates in the country from LILCO, she had to pay medical bills for her diabetes, she had to buy food, and all the rest. If it wasn't for the charities groups, she would not have made it.

Mortgages are hidden in here. They're signed in advance in blank. All of the RESPA forms are signed in blank. All of the completion certificates are signed in blank. The 3-day notice of rescission is signed in blank in advance. And not just once.

From a lucky happenstance, some person who saw the publicity about our suit called and told us that he had come upon some 68 cartons of records from Sterling Resources. We have all of the records from Harbor Crest and Sterling indicating everything we say is true. Multiple blank packets of papers signed sitting in with multiple contracts.

Mrs. McKay is another example. Mrs. McKay now lives in one room. She has brain cancer, heart problems, liver cancer. She owned her own home. She raised successfully three or four children who graduated from college. She is a black lady from Freeport.

She raised the three older children but her youngest is now, I believe, attending the University of North Carolina on a track scholarship.

She and her daughter in her daughter's senior year had to sleep in a room on a cot and a reclining chair because they were thrown out of their home. She is unable to travel here today because of the multiple illnesses associated with her.

I can show the subcommittee mortgages, plainly labeled "mortgage" signed in blank. This is not unusual. This is the rule. This is the way it's done.

This form plainly labeled "mortgage" is buried within the typical pack. And the contractor just lifts the bottom and says, sign here, sign here, sign here, and you noticed they're all marked in X. So the places are already premarked and the people are just shuffled through it.

It is a scam which can be eliminated and the first step is this bill, Mr. Chairman. This bill will help in that it will make some of the banks who might otherwise be tempted to buy loans which shouldn't be made to thinking twice about it.

It also is a first step because I believe the other items I have—the other remedies I have proposed will address the ills on the home improvement contractor end. Because they take the assets, hide the assets, and then they are unreachable.

I thank you very much, ladies and gentlemen, for the opportunity to make these remarks. It has been a long time coming, 3½ years since we started this class action. And we tried not only to represent the individual people but hopefully to stop it and seeing a Greek mythology in a Greek frustrating tragedy that it's becoming more and more difficult. They just change their names and start business anew.

Thank you, Mr. Chairman.

[The prepared statement of Harry Kutner can be found in the appendix.]

Chairman KENNEDY. You provided excellent testimony this morning, and I appreciate it.

Due to the fact that others have waited longer than I did, I just wanted to ask a general question that maybe the three of you might respond to, and that is the relationship between legitimate firms, whether it be Household, Beneficial, and specifically some of the major banks, and mortgage companies, and the difference between the legitimate roles of mortgage companies, and the illegitimate activities that all of you see each day in your day-to-day work.

I want to try to make certain that the legislation that we are talking about gets at whether or not these practices will continue, and most importantly gets at the relationship that exists between legitimate lenders and the illegitimate activities that you have encountered.

Mr. KUTNER. It would put a very substantial chill on legitimate lenders buying th[illegible] loans where they are subject to hold the elimination of the ho[illegible] in due course defense.

In my exam[illegible] I told you about Flushing Federal Savings which col[illegible]d in t[illegible] or[illegible]nal scam when I was representing the home im[illegible], and then I withdrew. That was a situation

where the bank president and other members of the bank were compromised, were bribed, to buy these bad loans. But if they paid value, ostentatiously at least on paper, they could feel insulated from the homeowner and then foreclosed.

Chairman KENNEDY. Mr. Kutner.

Mr. KUTNER. Sure.

Chairman KENNEDY. What I am really driving at is certainly you are going to be able to cite examples wher^e^ a bank was bribed?

What I am really driving at——

Mr. KUTNER. It is a legitimate bank?

Chairman KENNEDY. Yes. More legitimate institutions that aren't bribed at all.

Maybe, Mr. Elliot, you might have a thought about this.

Mr. ELLIOT. Yes. What happens when legitimate lenders get involved with these guys is that they forget that when you lie down with dogs, you get up with fleas. And the way you can tell the dogs is that they don't have any money.

One of the most effective aspects of the bill is the elimination of holder in due course. It will have the appropriate effect, I believe, of ensuring that these guys don't have any money. I mean, they will have no place to sell their loans. If they have to fund these transactions themselves, it won't happen. Despite the fact that an awful lot of income is peeled off in the contract, there is still some money that has to change hands.

Without the availability of funds by the sale of these loans, these guys are out of business. And it is not unreasonable to ask legitimate lenders to do appropriate due diligence as to who they get involved with.

And it is clearly reasonable to have a legitimate lender who then chooses to pass on those credit extensions—in mortgage based securities, for example—to do his own due diligence before he passes them on.

Chairman KENNEDY. If you take an instance such as Fleet that had its own finance company that enters this marketplace because they figure they can make money at this.

Mr. ELLIOT. Sure.

Chairman KENNEDY. If they are only going to make loans to people with good credit, they figure there's a whole marketplace out there that they are not taking advantage of, then how do you make certain that those kinds of abuses, where it is the same basic institution with the same parent company——

Mr. ELLIOT. You have to do your homework. You have to be competent at what you do.

If you decide to hook up with scoundrels—there is no free lunch. As Mr. Kutner says, if these returns are so unusually attractive, and you think that they are largely without risk, then you are nuts because there is a reason that those things are high priced. You just have to do your own basic due diligence.

I don't think the people in Fleet were evil in this at all. I think they took their eye off the ball, and they looked like good returns, and somebody said, well, you're insulated on these transactions, and so they did it. These things happen.

They are the consequence of your attention or lack thereof, and it is not unreasonable to be accountable for them.

Mr. KUTNER. Mr. Kennedy, we have seen a lot of legitimate banks who have bought these loans and who were not bribed, were not commercially bribed, and were not compromised.

Again, it is possibly an aggressive loan officer who doesn't see what is there to be seen, and is relying upon the HIDC defense. That is one of the very attractive aspects of the bill along with the elimination of other practices which are basically red flags to any legitimate lender like Mr. Elliot proposed.

Chairman KENNEDY. Thank you.

Ms. KEEST. Can I make one addition to that or two additions to that?

One is, not all of these loans are to bad credit risks. A lot of them are to people who could afford a loan that wasn't padded, and was made at market risks.

The other thing is that these substantive provisions are workable. One of them that I understand you are worried abeut, the UDAP provisions, have been on the law in 13 jurisdictions, some for as long as two decades. Experience has shown they are not a problem. They are workable.

Chairman KENNEDY. Thank you very much.

Mr. McCandless.

Mr. MCCANDLESS. Thank you.

Mr. Kutner, I have negotiated I don't know how many condition of sales contracts in the automobile and truck business where people sign instruments on evenings, late, early morning, weekends, children all around, having made a decision they want to leave the place with their new vehicle, and all of the environment that goes with this.

When Truth in Lending came in, it was fine. It answered a number of problems, but it didn't seem to mean anything too much to the average person in this environment which I am outlining to you.

That doesn't mean that everybody who came in to buy something wasn't interested in what they were signing.

I guess what I am trying to set up here is, how do we legislate and make it meaningful in a proper, if you want to use that term, commercial environment for people who have to read something?

We could put all kinds of things in front of people and say this is this and this is this, but in more cases than not where the problem begins to exist is the people are more interested in what they bought or how they bought it or the circumstance than they are in what you are telling them.

T[illegible] example that you gave us there where we had sheet after sh[illegible] in that particular instance of signed and blank documents, t[illegible] [illegible]u be the first step toward the slammer in my area if we fi[illegible] [illegible]nch of stuff after they'd signed it.

[illegible] [illegible] need some thoughts from you on how this legislation is to co[illegible] what I consider to be a serious personal deficiency [illegible] t[illegible] [illegible]ple who buy things.

[illegible] [illegible]R. You are never going to cure what Mr. Barnum re[illegible]on, t[illegible] s[illegible] [illegible]ker. They were there then; they've been there since [illegible] [illegible]ry.

[illegible] like Mr. Elliot said, the ultimate source.

I believe it was the hydra in Greek mythology, three-headed monster. Without any one of the heads, this conspiracy, this scam, cannot go forward. And without the source of funds, like Mr. Elliot proposed, these people are out of business.

The way they set it up, the Beyers of the world, B-e-y-e-r, the Northeast Holding, they go to a legitimate bank and establish a line of credit, obtain money available to them, and then they go and find the unscrupulous contractor to get it out there at the exorbitant rates.

But if you eliminate the type of loans and the practices which are addressed in this bill, you are going to dry up a tremendous amount of that money available to the unscrupulous middle man and the unscrupulous contractor.

This bill addresses it from the bank end and helps the banks because the banks are not doing better by making loans to these people. They are getting involved in scandals. It hurts their reputation, and it costs them. They are not dividing up the ill-gotten loot in the middle.

Mr. McCandless. If I understood Mr. Elliot's comment, if you are a legitimate financial institution, you don't involve yourselves in these kinds of things.

Mr. Kutner. No. Some of them do, Mr. McCandless.

Nat West Bank, which is a very legitimate and has never had a touch of scandal up in the New York area, got involved in some of these loans. Some of them were sold to them.

Possibly, if they were not insulated by that defense, they might have seen things that would have alerted them to the fact that maybe these loans shouldn't be made, or maybe a call should be made to find out if the work really was done, or if the people really understood the interest rates. That wasn't done. And I think this bill goes a long way to starting the remedial process to stop this scam from going on.

Mr. McCandless. Just a quick couple of questions. Someone comes to Ms. Keest and they say, well, I signed all of those papers in blank. In the State of New York, what kind of action would be forthcoming?

Mr. Kutner. Criminal and civil, sir.

Mr. McCandless. Isn't that pretty basic if I sign a lot of things in blank?

Mr. Kutner. They're void. Any real estate document is void in New York if it is signed in blank and later completed.

The problem is that we have been—criminally, there is fraud involved, obviously: Bank fraud, mail fraud, wire fraud. A lot of statutes apply, but typically the prosecutors nationwide and the other attorneys I've spoken to are very reluctant to take this on because it is very, very time consuming, very staff consuming.

To give you an example, the eastern district of New York, the U.S. Attorneys Office, I believe, has had three or four U.S. attorneys, seven FBI agents, and two IRS people working on this for 3 years, and they still haven't gotten the indictments out. They have been submitting evidence to the grand jury. But they seized something like 40 filing cabinets full of record from Sterling Reese offices. The FBI went in on a search warrant. It is very, very time consuming for the prosecution.

So, yes, there are crimes committed. Yes, there are civil remedies, but these people, the people they prey on, Mrs. Burger didn't have a phone. Many of these people don't have phones. They don't have access. They don't have political clout. They don't call a Congressman McCandless or a Congressman King. They don't have the wherewithal and knowledge how to get to the appropriate authorities, and they don't have the money to hire attorneys.

Mr. McCANDLESS. If I am signing things in blank, what is going to change the environment in which I negotiate something if we put 10 more laws on the books?

Mr. KUTNER. Because you are drying up the availability of the money which funds the whole scheme. That's what this law does.

Mr. McCANDLESS. Now, Mr. Elliot, very quickly. We are talking here about some areas of liability where the language is very grey and uncertain relative to the mix that we are talking about here.

Do you have any comments about the language as it now exists?

Mr. ELLIOT. You are always at risk as to whether or not somebody is going to interpret, in one way or another, what that language would have been. I mean, that is the dilemma that financial institutions always face in these kinds of legislation.

That is typically why you get people saying: Just no.

Mr. McCANDLESS. Translate that for me, "just no." What does that mean?

Mr. ELLIOT. Well, in other words, where the industry lines up and just says no because you are against the vagueness of some part of the legislation or you are afraid that it is the entree into greater controls.

But there are some things that are just so wrong that you have to go along with legislation to correct them. I agree with you that many of the things that are described in the bill are not going to have much of an effect. I mean, greater disclosure does not stop a crook, and it does not protect the person who does not do their own personal due diligence. This is not going to stop that.

But cutting off the source of funds does and requiring the people to do appropriate due diligence before they accept business relationships with scoundrels is going to work. It certainly has gotten the attention of the mule already.

Mr. McCANDLESS. Ms. Keest, I don't have a work sheet on that California loan. Could you make that available to us, please?

Ms. KEEST. Sure.

Chairman KENNEDY. Thank you, Mr. McCandless.

Ms. Velazquez.

Ms. VELAZQUEZ. Yes. Mr. Elliot, I am very, very pleased to hear about the effort that Household Finance has made to reach out and service Latino homeowners.

Is it your contention that Household Finance will end its commendable outreach to Latinos and other minority borrowers if H.R. 3153 is passed as introduced last year?

Mr. ELLIOT. I'm sorry. I didn't get—I got most of it. Are you asking if this would cause us to end the program?

Ms. VELAZQUEZ. I am just wondering if you will end the outreach that vo" l 'e been making in the Latino communities if we passed H

Mr. ELLIOT. No. One thing has very little to do with the other. We are doing it simply because we have brought our cost down to the point where we can afford to go back into the inner cities and service that customer group without having to transfer into the inner cities a pricing structure that we could economically justify, but could not optically justify.

The reason that you don't see people in those markets today is because it became very expensive to do it. And to charge the rates that you would have to, to make it economically viable, was almost unsustainable from a public relations point of view.

Bringing your costs down to the point where you do not have to charge excessive rates is the remedy to that situation, and that is what we have focused on over the last several years.

So now it becomes not a matter of doing some sort of social good, but a matter of business opportunity to make money. And that is the most sustainable of relationships, I believe.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman KENNEDY. Thank you, Ms. Velazquez.

Ms. Pryce.

Ms. PRYCE. Mr. Chairman, thank you. I commend you for holding this hearing. This is a very serious problem we are having. I am tuned into it now because of your efforts.

However, I missed your testimony, all of you, and I am very sad that I couldn't be here. Be assured that I will digest it completely, but I don't have any questions because I missed the major portion of it.

Chairman KENNEDY. Thank you.

Lucille Roybal-Allard.

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman.

First of all, I would like to begin by commending Ms. Robins for her testimony. I know how difficult it is to participate in hearings such as this, and talk about your personal problems. I want to assure you that your testimony and your presence will make a difference and help ensure that others do not suffer in the same manner.

Ms. Keest, you mentioned that you thought there were parts of this bill that we needed to be careful about in terms of weakening current law, and that it wasn't as strong as you hoped that it would be. I would appreciate it if you would, perhaps, highlight a couple of the areas in which you have concerns.

Ms. KEEST. Yes. I would say that there are three or four that were improvements on this bill over what came out of the Senate.

One is covering open-end credit which can be just as dangerous. I would simply refer you to a written testimony where we have an example of the way, with very little way for anybody who even is exercising due diligence in the capacity that the average consumer has, could figure out that they end up having a balloon payment of $66,000 at the end of it. That is after already paying $164,000.

So the open-end credit exclusion is something that is a big concern to us because I think we will be back here in hearings for dealing with that loophole if we don't cover it now.

The other is the UDAP provisions, what we call the UDAP provision, the Unfair Deception Acts and Practices. Those get to the heart of the matter which is the equity theft, the equity skimming.

The specific prohibitions are critical because they are the most common tools that have been used, but greed can be a very, very powerful incentive to the imagination. What I think is that if we have the substantive prohibitions that is like saying you can't mug somebody with a gun, but not outlawing the mugging.

I think what the UDAP provisions do in saying that you can't make a loan that you know will fail, you can't take advantage of vulnerable people, that's outlawing the mugging. And that is why it is important to protect these.

I, unfortunately, have not seen the working proposal about requiring a debt-to-income ratio to trigger the substantive prohibitions, but I am very concerned about—as I understand the way that may work—I am very concerned about that; it makes it very unworkable. And these people have identified that the assignee liability provisions are really critical, and I think that would really confuse things a lot and make it significantly weaker. Those, I think, are the—no balloons, the provision about balloons is another one.

That open-end credit shows a 15-year balloon. For these people either foreclosure, refinancing, getting deeper in debt through this kind of pyramiding scheme or for sale after they have lost all the equity is really the only way out, whether the balloon comes at 1 year, 6 years, or 10 years.

That's why with these loans—we are not saying you outlaw balloons, just balloons on these loans.

Those, I think, are the most critical ones. There are some others that I think are extremely important like permitting States to be able to regulate the loans; amending the Federal preemption of first usury ceilings on nonpurchase money mortgages is important so that those jurisdictions who want to can look to the problems that exist in their jurisdiction and if they need stronger answers, provide them without the Federal Government getting in the way.

Ms. ROYBAL-ALLARD. What is it that Texas does that the rest of the States don't do that has helped to prevent this kind of abuse?

Mr. ELLIOT. They outlaw home equity lending.

Ms. ROYBAL-ALLARD. Except for home——

Mr. ELLIOT. That is a solution that is not to be hoped for, I hope.

Ms. ROYBAL-ALLARD. Mr. Kutner, you mentioned this was a good first step. What other steps would you like to see?

Mr. KUTNER. This is aimed at drying up the source of the money which fuels the furnaces of the scheme. The additional steps I outline in my written testimony. It is mainly seeking to be able to pursue the unscrupulous contractor and financier.

To give you an example, Mr. Beyer, before he changed from Northeastern and resurrected and came out of the ashes as Sterling and now he is as Home Trust, he changed the title to his house, cars were taken out of his names. We went after any number of ways of access to try to attach them to stop him from making himself asset-proof and he had already done it.

If we had Federal statutes, the forfeiture statutes, which have been applied to the drug trade and some other banking frauds, applied to this type to not enable these people to steal and then insulate themselves from being able to be subject to recovery, it would be very helpful.

This bill starts the process by stopping the funding, so it is on the one head of the hydra, the third head.

The first two heads would be very well served by continuing the bill, by continuing the bill's work, and allowing the tracing of the assets, piercing of corporate veils, seizing the funds wherever they end up in whatever name they end up in order to take the profit motive out of it for the crooks.

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman.

Chairman KENNEDY. Ms. Maloney.

Ms. MALONEY. Mr. Chairman, as you know I've been in the escheatment hearing all morning. I just congratulate you on this hearing, and will certainly follow up with reading all the material.

Chairman KENNEDY. Well, we thank you. Carolyn has been an excellent member of the subcommittee who has been helpful on this issue in the past particularly as it pertains to people in the New York areas.

Ms. Robins, did you have another comments?

Ms. ROBINS. Yes, I do, Mr. Kennedy.

I would just like to say—in fact what Mr. Kutner say about signing forms blank and the right of rescission forms. I am not a stupid person. I am a college graduate, and I also signed rescission forms.

I was forced to sign them. I was told to sign them right in the office before I even got the money. Sign them now or you won't get your check.

And anything you can do to stop something like this.

Chairman KENNEDY. Yes, ma'am.

I think the point that Mr. McCandless raises is a legitimate one. I just went through a refinancing of my own home in Brighton, and there is a stack of forms this thick that you have to get through.

Ms. ROBINS. Yes. Tell me.

Chairman KENNEDY. And the fact is that trying to—at a certain point, there is a guy sitting across a desk from you and he is saying sign, and you're signing because you know what the interest rate is and you know what the basic terms of the mortgage are, and you are not looking at all of the details. Golly, it would take you 1 month's worth of work to read every one of those forms.

So I think the notion that we could fix this issue by doing another form is what Al was driving at, which is not, I think, what the purpose of this legislation is.

What we are trying to do is build a wall between the way the system works today, which provides credit to the kinds of companies that Mr. Kutner was referring to, and the kind of legitimate lenders that Mr. Elliot represents here and who we are going to hear from in the next panel.

So you are right, Ms. Robins, to suggest that. Nobody, I think, comes away from this hearing with any question about your intelligence.

What people come away with is the fact that despite being a person of great capability in terms of your articulateness and the kind of heartache that you've gone through, that nevertheless you, plain and simple, have been taken to the cleaners.

What we are trying to say is there are going to be other people out there. Mr. Kutner brought forth a lot of people that perhaps

are not as educated or as aware as you are, and those individuals do fall prey. I mean, you get at somebody who is blind.

We had witnesses before our subcommittee when we had this hearing up in Boston, people were blind. They had folks that would go to their houses and threaten to beat them up if they didn't make these payments. I mean, it was incredible.

People that didn't know how to read or write, who, on the form, just put an X as their signoff for these 30 and 40 percent interest rates. That's the kind of operation you are talking about.

So I think what we are trying to suggest is that nobody is trying to come up with a form that prevents this. What we are trying to do is to build some walls to make certain that the kind of collusion that was taking place, whether it was known or not known. Even Mr. Elliot would suggest that these guys, if they weren't knowledgeable, were wilfully ignorant.

In any event, I think what we are trying to do is come up with some reasonable legislation that makes an attempt at preventing these practices.

I do appreciate the comments that Ms. Keest has made about some of the areas where we might be able to still strengthen the legislation. We look forward to continuing to work with you and your organization as we move through the process.

I want to thank all of the witnesses from our first panel for what I consider to be excellent testimony this morning, and we look forward to working with you, and hope that we don't have more of these cases in the future.

Thank you all very much for coming and testifying.

I will ask our second panel of witnesses to come forward. We will, again, have your entire written statement submitted for the record, and we'd ask that you limit your oral statements to 5 minutes in the interest of time.

The subcommittee will come to order. As I say, we're going to try to get this machine cranked up. I'm not sure it's going to work, but we're going to give it a shot here. I'm going to ask all the witnesses to please try to summarize your remarks and limit them to 5 minutes so that we can enter into some questions, which is where most of the understanding about what you're talking about is going to take place.

Our first witness is Mr. Joseph Falk, who is the vice president of the Metropolitan Mortgage Co. Mr. Falk also serves as presid t-elect of the Florida Association of Mortgage Brokers and he is e today on behalf of the National Association of Mortgage Brol

r. ılk, thank you very much for being here with us this after-no . Pl e proceed with your testimony for 5 minutes.

I ' OF JOSEPH FALK, NATIONAL ASSOCIATION OF GAC BROKERS; VICE PRESIDENT, METROPOLITAN GAC CO., MIAMI, FL

r. FA] ank you, Mr. Chairman and distinguished members Hou Subcommittee on Consumer Credit and Insurance. ai for th opportunity to testify.

h Falk and I represent the National Associa- r rs. We are a professional society, represent-

ing members throughout the country. We match potential borrowers to a wide variety of prospective lenders. Recent studies have indicated that mortgage brokers represent over 45 percent of the loan originations in the United States, and this legislation will affect certain segments of our business.

I also serve as president-elect of FAMB, founded in 1959, when our first licensing provisions were implemented in the State of Florida. NAMB is committed to the highest level of professional standards and believe in full disclosure and consumer protections. No problem. But we also believe in making home ownership and equity loans available to all members of society.

Previous testimony has highlighted abuses in the home improvement industry, where financing is tied and intertwined with other purchases. But the proposed legislation would include thousands of transactions entered into voluntarily with knowledge and disclosure that are not the results of high pressure tactics.

Unfortunately, it won't stop predatory lending. The proposal includes so many rules, regulations, prohibitions, and unlimited lender liability that it denies access to credit to those individuals who are not currently served by such credit sources. In the testimony this morning, we heard egregious examples of consumers being taken advantage of and we strongly agree that the unscrupulous members of this group need to be curtailed.

Unfortunately, the abuses are involving both the nonconforming market and the conforming market. Signing documents in blank is outrageous, but we must focus on both sides of the issue.

Consumers like these may be denied credit; anyone who is working at home or is self-employed and doesn't have consistent, historical, provable income; a senior citizen who needs money for medical treatment, but can't qualify without a cosigner and doesn't want to get a cosigner from their family; the homeowner who faces foreclosure for unpaid real estate taxes or condo fees and anyone who spends a larger than traditional percentage of their income on housing; the minority applicant, finally, who has equity in their home and wants to pursue the great American entrepreneurial dream.

I bring to your attention the case of Denise Mitchell of Sanford, Florida. Hi, Denise. A mixed marriage, prior divorces, owning their own home free and clear, dreaming of owning their own business. They shopped at various banks and were turned down. Their credit was bad primarily due to the divorces. They went to a nonconforming lender. They got their loan, they started their business, and they eventually employed 50 people.

This statute would have prohibited this type of loan because their historical income pattern would not have supported the new business venture. Some borrowers enter into transactions in bad faith. Creating lender liability with such heavy penalties invites those individuals who wish to take advantage of the rules to target lenders who, in fact, have acted in good faith.

The end result, taken all together, will be that some lenders just won't extend the credit under any set of circumstances. And if there is credit available, it will be at significantly higher costs.

Our common goal is not to take the easy way out by just prohibiting transactions. It's not fair and I think, with respect, it's too

easy. The better road is to enact consumer protections, which Florida has enacted for 35 years, and, at the same time, allow for the extensions of credit to all members of society.

We can support the following concepts. Separate those who provide financing from those who provide home improvement services, a firewall, if you will. Disclosure requirements should be informative and not judgmental. The requirement to disclose and verify income should be deleted. Balloon-type mortgages with terms of greater than 3 years should be allowed and lenders should be able to charge points on refinancing.

The abuses outlined in prior testimony dealt primarily with 1-year interest-only rolling loans and points over and over and over again. By limiting the balloons to periods of over 3 years, you've basically solved the problem of churning.

We urge the deletion of the unfair and deceptive trade practices section. This, conceptually, creates an unfair and deceptive trade practice with a fiduciary responsibility to the lender. The lender would be required to judge the capacity, the willingness, the wisdom, and the ability of borrowers.

The agent, the counselor, the representative, the mentor, in direct conflict with arm's-length transactions between willing participants. Should borrowers be at the mercy of a loan committee who is going to decide what's in the best interest of the consumer? Given knowledge and disclosure.

Each State should be responsible for rates, points, and unfair and deceptive trade practice sections. TIL is a disclosure statute. If this proposal passes in its current form, we believe that there will be a restriction of credit to people like Denise Sanford. The unscrupulous actions of the many we fear will limit credit availability.

Please work with us. We can do it both ways. We can get consumer protection and provide the free flow of credit.

Thank you for this opportunity.

[The prepared statement of Joseph Falk can be found in the appendix.]

Chairman KENNEDY. Thank you very much. I believe Mr. Judis is a friend or an acquaintance of Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman. He is a fellow Californian. That's about 7 hours from here, the way I fly. I'm very pleased that Mr. Judis was able to join us today because his background lends an awful lot to the subject. I want to take a minute to highlight a few of those points.

Mr. Judis has been a mortgage broker since 1964. Unlike many, shall we say, Republican-oriented type people, in 1981, California Governor Jerry Brown appointed Mr. Judis to a special task force to develop rules under which brokers in the State could write loans for California borrowers with more than one lender.

In 1983, then Los Angeles Mayor Tom Bradley named Mr. Judis to a blue-ribbon committee charged with investigating redlining practices. Mr. Judis has been, for many years, a main source of funding for homeowners in disadvantaged neighborhoods ignored by the larger financial institutions.

He was principally involved in the setting up and founding of the California Independent Mortgage Brokers Association in 1973. As a founding member, he also became president. In 1989, he formed

his own company, AAMES, and is chairman and chief executive officer of that financial corporation.

So we have a gentleman here, Mr. Chairman, who is, I think, knowledgeable and can respond to many of the problems that we see here in our legislation.

Chairman KENNEDY. Thank you very much, Mr. McCandless, for your opening statement about Mr. Judis' qualifications. We look forward to hearing from you, Mr. Judis. Please proceed for 5 minutes.

STATEMENT OF GARY K. JUDIS, LEGISLATIVE CHAIRMAN, CALIFORNIA INDEPENDENT MORTGAGE BROKERS ASSOCIATION

Mr. JUDIS. Thank you very much, Mr. McCandless and Mr. Chairman. Before I introduce myself more formally, let me say that although knowledgeable, I'm quite human and subject to error, as most of us are. This subject, I think, is one that is very sensitive, very fragile, and has to be approached, I think, with a great deal of understanding.

Mr. Chairman and members of the subcommittee, I am Gary Judis, legislative chairman of the California Independent Mortgage Brokers Association [CIMBA]. I am also CEO and chairman of the board of AAMES Financial Corp., a publicly held loan brokerage firm. I thank you, Mr. Chairman, for the opportunity to testify today.

We have provided copies of my complete testimony to the subcommittee, but I'd like to summarize that testimony now. At the conclusion of my summary, I will be happy to respond to any questions that you may have.

CIMBA is a nonprofit professional society comprised of individuals and firms licensed as real estate brokers, engaging primarily in the pursuit of making and arranging real property equity loans on behalf of Californians. I am here today because my association believes that the authors of H.R. 3153 are interested, frankly, in the same goals as we are; to eliminate the abusive lending practices of the few in the industry who would take advantage of the borrower, especially in times of great stress, without disrupting the flow of funds provided by the industry, the vast majority of whom are honest and credible and, frankly, who serve a very legitimate need to homeowners with equity in their property.

I might quote Mr. Kutner in saying that I, also, am very unhappy with the fact that so few get so much publicity. That's also quite true of the mortgage lending industry throughout this country. When I hear about documents and claims and deeds being signed in blank, I can tell you that that conduct is not only reprehensible, but it's criminal. In California, in most instances, we would move vigorously to dispose of those people properly.

We understand that there have been abuses and our association recognizes that lax and nonexistent regulation has created some real cause for genuine concern by Congress and, thus, the introduction of your bill. Recently, we have become familiar with the term "disparate impact," identified by the Justice Department recently as being the result of well-meaning procedures which, in fact,

produce patterns of lending that exclude equity borrowers from economically disadvantaged neighborhoods.

That's a nice way of talking about another kind of redlining, but, frankly, you and I all know what they mean when they say economically disadvantaged. It's a polite way, frankly, of dealing with lending racism, which I have been fighting vigorously most of my life and certainly for the 30 years that I've been in this industry.

While we support the goal of H.R. 3153 to eliminate these abuses, we do not believe that the measure, as constituted, will accomplish that objective without creating disparate impact amongst the persons home equity lending can best assist. Once again, we applaud the notion that this legislation is being introduced and we very much want to be part of constructive results.

In California, we have developed well-regulated systems of real estate law over almost 40 years. Someone here earlier testified that it was an imperfect system. I'm here to agree with you. It is absolutely imperfect. But to our knowledge, it is one of the most well-developed systems in the United States.

I have letters from enforcement agencies and the chief regulator of our industry that talk about active prosecutions for the very kind of conduct that was spoken about here earlier this morning. Before discussing in greater detail this regulatory scheme, let me address the points, Mr. Chairman, that you asked in your letter to us.

If triggers are to be retained in H.R. 3153, we would recommend they be as follows. The interest rate at consummation of the transaction will exceed by no more than 12 percentage points the 30-year conventional FNMA fixed rate mortgage. In other words, compare mortgage rates to mortgage rates, not mortgage rates to Treasury instruments.

All prepaid finance charges payable by the consumers defined in the existing laws, found in regulation Z of the Truth in Lending Act, on or before closing will exceed the greater of 12 percent of the total loan amount or $400. Second, we support the means of computing annual percentage rates of interest, including the certain fees that may be excluded in calculation of the APR, as now contained in Truth in Lending.

Before some comments that I heard earlier, I had this lovely portion of my presentation that was going to tell you about the wonderful disclosure laws we have in California, and they, in fact, are wonderful. [illegible]t I'm so concerned that these comments will be misinterpreted [illegible] I will merely say this.

Someone [illegible] saying piles of documents, difficult to read, you're in a hurry [illegible] you're under duress. With all due respect to the crimi[illegible]nent in our industry, they should be put away and that's [illegible]d no one will disagree with that. But I suggest that consu[illegible]s, [illegible]s, should be exposed to a little more education in the [illegible] what they sign and how seriously they take the writ[illegible]rd, [illegible]cause we live in a country, ultimately, that operates [illegible]s of understanding that more often than not are literally

[illegible] anything. I am very conscious of litiga[illegible]s of performing my responsibilities. Mr. [illegible] in a hurry to refinance your house, but

I would suggest that perhaps you should have taken just a few more moments to have read carefully all those documents, because it's not inconceivable that someone would have taken you to the cleaners.

Chairman KENNEDY. Yes.

Mr. JUDIS. Our disclosure statement in California is mandated by the State on all equity loans secured by real property. In graphic terms, 12-point type. So if you're myopic, we can make it 14-point type. Do not sign this document if you are fearful of the fact that if you can't make a balloon payment or any payment, your home will be lost in foreclosure.

I don't know how much more plainly we can do this since years after the fact we cannot rely on what he said or she said. We have to have something evidentiary to lay our hands on that tells us what people agreed to and what they did not agree to. If we disallow the seriousness of contractual understandings, we're undermining all of American business, not just mortgage lending. Let's not be foolish and hasty in making these judgments.

California makes every effort possible, and I say possible having said earlier that our system is, yes, imperfect and constantly evolving. Finally, as a fifth matter of principle, my association is against all unfair, deceptive, and evasive business practices, but we would have to discuss specifically to determine whether or not one or another would be considered unfair, deceptive, and evasive, as judged by reasonable people.

We see no reason why, from the regulatory consumer protection standpoint, open-end loans should be treated any differently from any other loan. If anyone can explain to me the difference between ripped off on an open-end loan or a closed-end loan, I am all ears.

I know you're in a hurry for me to wind up, so I won't bore you with the rest of the summary. Suffice it to say that we are, in spirit and in concept, absolutely with you. We are in disagreement on certain technical aspects of the legislation.

Thank you very much.

[The prepared statement of Gary K. Judis can be found in the appendix.]

Chairman KENNEDY. Thank you very much, Mr. Judis. I'm glad you clarified that in the end.

Mr. MCCANDLESS. Watch what you're saying.

Chairman KENNEDY. Don't worry. Thank you. I made somewhat certain that the documents were in order by having my own counsel there first, but, nevertheless, I appreciate what you're suggesting.

Nancy Donovan is the president of NOVUS Financial Corp., which is a Dean Witter company. NOVUS has been a leader in the consumer lending industry for over 30 years. She is testifying today on behalf of the American Financial Services Association.

Ms. Donovan, we are looking forward to hearing your testimony today and please proceed for 5 minutes. Thank you.

STATEMENT OF NANCY DONOVAN, AMERICAN FINANCIAL SERVICES ASSOCIATION, PRESIDENT, NOVUS FINANCIAL CORP., LIVERWOODS, IL

Ms. DONOVAN. Thank you very much. You've explained who I am and where I'm from, so I'll start from there. Let me begin by commending your willingness to make changes to this legislation. The modifications that you have already proposed appear to address many industry concerns. In particular, the proposal of a debt-to-income ratio trigger is a major improvement and we encourage you to make this change.

I am confident that a bill can be crafted that will protect consumers without imposing requirements that would restrict consumer availability. We look forward to working with you on this legislation.

The purpose of this bill, as we understand it, is to remedy unjustified foreclosures of second mortgages resulting from abusive lending practices. Abuses have occurred where vulnerable consumers with significant equity in their homes were targeted by home improvement contractors and other third parties. In most cases, it was clear from the outset that the consumer was unlikely to be able to afford the loan.

In other words, foreclosure was a likely occurrence and not an unanticipated event. These practices harm not just consumers, but legitimate mainstream lenders. AFSA members have a strong interest in the elimination of such abuses.

Mr. Chairman, let me also mention that my company makes no loans that would be affected by this bill. This is true of many other AFSA member companies. Yet, we are concerned about the approach the bill takes because we think it could curtail legitimate loans that consumers need for a host of purposes. Even with the enactment of this legislation, abusive lenders could avoid regulation. The principal problem is with the bill's definition of high-cost mortgages.

As the bill is currently drafted, the definition focuses on two components of a second mortgage; interest and points in excess of a stated ceiling. A loan which meets either one of these triggers cannot also have certain loan terms, such as a balloon payment feature, and cannot be transferred unless the assignee remains liable under the loan. While, technically, this does not forbid the making of such loans, its practical effect is to prohibit them.

Why? Because the forbidden terms are often essential ones if the loan is to be economically viable or if the lender is able to securitize it. To put it another way, a loan that is not permitted to contain these terms is a loan that will probably not be made.

Our concern is simply this. A loan is not abusive merely because it c[illegible]ins a single pricing feature that appears high. In some ca[illegible] such a loan is suitable and affordable for a particular custo[illegible] a[illegible] represents no default or foreclosure risk, even though it con[illegible] one or more of the loan terms that would be prohibited un[illegible] t[illegible] bill.

R[illegible]lating or prohibiting the pricing terms of loans will not [illegible] a[illegible]sive lenders. Such parties can avoid coverage by simply p[illegible]ng [illegible]r loans below the trigger rates. They would escape regulat[illegible] high-cost lenders, but could continue to prey on consum-

ers by making loans that are unsuitable or unaffordable for a particular customer or that contains terms that, in combination, are unfavorable.

The terms that could not be included in high-cost mortgages are important components in the pricing of many loans and are beneficial for many consumers, as illustrated in the *Washington Post* articles attached to my written statement. The market must continue to be able to meet customer needs by devising many and varied products that carry a wide range of features and pricing.

While we know it is not the intent of the bill to impede legitimate lending, it is very difficult, if not impossible to avoid such a result when directly or indirectly regulating the price and substantive terms of loan products. This conclusion was confirmed in a recent study by the New York State Banking Commission which is attached to our written statement. It found that where rates are deregulated, the availability and variety of credit products increased significantly, with major benefits to the consumer.

Mr. Chairman, mortgage lending abuses cannot be addressed by focusing on isolated loan terms or by trying to restrict loans that someone defines as too costly. Cost is relative to levels of risk.

We urge the subcommittee to consider the alternative recommendations that are made in our written statement. Finally, as the subcommittee explores ways to address mortgage lending abuses, we urge careful consideration of regulations under the Real Estate Settlement Procedures Act [RESPA] which will take effect in August.

In issuing the regulation, HUD stated that it targeted abuses disclosed in congressional hearings. RESPA should eliminate most of the abuses and we believe that any legislation should take the impact of these new requirements into account.

AFSA greatly appreciates the opportunity to present its views and hopes that our testimony assists the subcommittee in its deliberations. Thank you very much.

[The prepared statement of Nancy Donovan can be found in the appendix.]

Chairman KENNEDY. Thank you very much. The next witness is Terry Drent, who is the executive director of the Washtenaw County Council on Aging, which is a nonprofit organization that represents senior citizens throughout southeastern Michigan. Mr. Drent has developed several mortgage and tax foreclosure prevention programs and we appreciate you taking the time to join with us today. We look forward to your testimony. Please proceed for 5 minutes.

STATEMENT OF TERRY DRENT, EXECUTIVE DIRECTOR, WASHTENAW COUNTY COUNCIL ON AGING

Mr. DRENT. Thank you, Mr. Kennedy and members, for inviting me to participate in today's hearing. I want to commend your aggressive investigation and exposure of the reverse redlining issue. Many of our most vulnerable homeowners, the elderly, people with health care problems, the underemployed, and the disadvantaged are being targeted by unscrupulous lending institutions because these homeowners have substantial equity in their homes.

This population is experiencing difficulty paying for health care, home repairs, and basic sustenance. They find it necessary to supplement their incomes with debt and the only credit opportunities available to them consists of home mortgages at double and sometimes triple traditional market rates. They go along with expensive administrative fees and points.

These loans are marketed as part of vicious secondary mortgage schemes involving home improvement scams and debt consolidation loans. The purveyors of these loans know they're causing great hardship to the customers, but their desire for incredible profit takes precedence over any ripple of compassion they might possess.

As the founder of United Companies Financial Corp., said, "Mama might let some other payments slide, but she's going to be sure to pay that house note first." I would suggest that the payment mama would let slide would include bills for health care, property taxes, and food.

As to the 77-year-old widow in Whitmore Lake, Michigan, who had Alzheimer's disease and, like many, was also blind, she borrowed $12,729.50 to pay her back property taxes and medical bills. She was charged over 25 percent interest and her monthly payment was $350 a month out of a monthly Social Security income of $520. The loan had a 3-year balloon payment. She could not afford the payoff, so she was refinanced. She defaulted on her loan and was refinanced again.

In an 18-month period, her debt increased from the original $12,729 to $39,500. She received a total of $4,000 from these additional transactions and the rest went for points and fees. She lost her home of 40 years last summer and she now lives in a government-subsidized nursing home.

I would like to suggest that this story is not particularly unique. It's been documented and duplicated many times throughout the country.

One of the more insidious methods used by some mortgage companies to obtain clients starts with the purchasing of delinquent property taxes. Frequently, a subsidiary or agent of a mortgage company will buy a homeowner's delinquent property taxes. The homeowner typically has two choices. Either they lose their home through a tax foreclosure or they pay off the tax purchaser with the high-cost loan. The homeowner frequently gets a mortgage they cannot afford to pay.

Recently, First Boston Corp., which is owned by Credit Suisse, developed a strategy to purchase all delinquent property tax liens from entire cities and counties. In effect, we have foreign bankers collecting taxes on behalf of the American Government by either foreclosing on the homes of our citizens or taking advantage of their desperation and economic vulnerability with high-cost loans. This is an unacceptable practice.

The Home Equity Protection Act is a great start in controlling an abusive and underregulated system of lending. The proposed triggers for defining a mortgage as high cost are appropriate. They are high e[illegible] to allow for normal market-driven lending and have a ceili[illegible] will require care for an expensive and possibly suspect l[illegible] The proposed disclosures and timing of disclosures will gi[illegible] consumers and their representatives necessary infor-

mation with which to evaluate the propriety of entering into a high-cost loan.

However, more disclosures is like putting a beeper in a red flashing light on a shark. If you're in a house that's burning with needed home repair and medical expenses, you'll jump into the water and take your chances with the shark. Assigning liability would ensure that the industry would monitor itself, which would be more effective than the lackluster government regulation we've seen in the past.

With assigning liability, the lending industry would develop internal checks and balances that would halt any abusive lending practices in the loans that they purchase.

There should be prohibitions on balloon payments, though some are legitimate particularly as bridge loans for home construction. However, these loans generally do not meet the proposed interest and fee triggers for high-cost loans, so most of these transactions would not be affected.

The civil liabilities section will allow consumers to seek protection from lending abuses under this act. However, I suggest that damage recovery limits be increased to ensure stricter compliance. I feel that we need to empower the legal eagles to go after the loan sharks.

The problems associated with reverse redlining are severe. Federal legislation is needed to help solve these problems associated with high-cost loans and an abusive mortgage system. The practice of reverse redlining is threatening the sanctity of the American dream—home ownership for those who can least afford it.

This activity is wrong, unfair, and unjust and it needs to be stopped. I want to thank the subcommittee again for your efforts in bringing common truth and common decency into the legislative process and to tell you, Mr. Kennedy, that the senior citizens of Michigan support you in your efforts.

[The prepared statement of Terry Drent can be found in the appendix.]

Chairman KENNEDY. Thank you very much, Mr. Drent. Mr. Falk, you spoke in fairly direct terms about what your view of the shortcomings of this legislation are, indicating that there were a lot of legitimate operators that provide these kinds of mortgages to people that you feel have a legitimate right to obtain these mortgages.

But as I understand, on October 25, 1992, according to the *Miami Herald*, your company entered into a settlement with the State of Florida in which you were required to refund $350,000 in loan origination fees. The article cites one case in which a northwest Miami woman borrowed $6,255 from Metropolitan, backed by an equity in her home. She received in cash just $2,317. The rest of her money went for life insurance, loan application fees, and other costs.

In this matter, the State of Florida maintained that Metropolitan demonstrated, and I quote, "a manifest lack of honesty, integrity and competency as to financial transactions." It just seems to me that these are the kinds of instances that lead us to the legislation that we're talking about.

What I'm trying to point out to you is that while you might have some explanation for those kinds of activities that your company

was associated with, the fact remains that there have been enough instances that have come forward to this subcommittee to lead us to believe, as well as the U.S. Senate to believe, that there are serious abuses that are taking place in your industry and that they need to be cleaned up.

Do you have a comment?

Mr. FALK. Yes, sir. I would like to comment, Mr. Chairman. Back in 1988, the Florida Department of Banking and Finance took the perspective that mortgage brokers had a fiduciary responsibility to borrowers. The FAMB, our company, and many, many other companies within Florida disagreed with that perspective.

We immediately settled our case, offered a series of different rules and regulations and procedures that we thought were proper to correct perceived abuses.

Chairman KENNEDY. I appreciate that, Mr. Falk.

Mr. FALK. May I also——

Chairman KENNEDY. If you'll keep it brief. I don't want to use my time for a long explanation.

Mr. MCCANDLESS. Mr. Chairman, let's use a little bit of my time, because I think——

Chairman KENNEDY. You can use your time. That's fine. You can use your time, if that's what you choose to do. Go ahead. I just don't want to end up using my 5 minutes in a long explanation over what these additional procedures you took into account that led you to a situation where she got $2,317 out of $6,255 that she borrowed.

Mr. FALK. We, as an association, as a company, worked with Gerald Lewis, our comptroller, to rewrite Florida statutes. I served on that task force to implement appropriate protections. Gerald Lewis, our comptroller, wrote a letter to each and every one of our elected officials from Florida supporting our position that a State exemption is warranted given Florida's very, very proconsumer statutes.

We believe this is an adequate protection.

Chairman KENNEDY. Thank you very much, Mr. Falk. I want to ask that Bruce Marks come up, if we could make room for him at the table. Mr. Marks is a fellow who is a constituent of mine who has been responsible for bringing about settlement with the Fleet Bank that concerned, I believe, in excess of 18,000 individuals that find themselves in these circumstances.

Now, all three of you, with the exception of Mr. Drent, have indicated that these home equity rip-offs affect just a small number of people and that this legislation we're providing is in some way overreaching, that it in some ways is using too big a club for a very small number of abuses.

It is not my experience, and I would like Mr. Marks to comment on whether or not these kinds of abuses are, in his opinion, extensive and if he could give us any specifics on the extent of the kinds problems that poor people are facing out there, I would apprec e it.

r. Marks.

r. M S. I appreciate the opportunity. Let me try to keep it . In te, except Texas, you can have 50 or 100 or 1,000 d and say to the representatives this is what is

going on in my State. UNAC, which is the organization that I'm with, the Union Assistance Corp., when you scratch the surface and you go to the Registry of Deeds, you will find this practice pervasive.

We're saying let the market work. We're not saying hire on more regulators. What we're saying is the holder in due course issue will let the market, but let's not get caught up on what are the documents, what are the disclosures. While they're important, this is a fundamental piece of legislation. It is conservative. It's saying everybody should be accountable and that we think it's unconscionable that you have the industry, who, if they're credible and legitimate, should say we want to police ourselves, we want to get rid of the bad apples.

Well then, they should do that. They should stand up and say this is the legislation that gets rid of the bad apples, and they're in every State. So what are they trying to protect? No one can afford a 20 percent interest rate. It's unconscionable. This is what this legislation does. It lets the market work.

The people who drove up here from Georgia and from elsewhere overnight, you go back and all the representatives can go back to their own States and they'll find the same thing. So we strongly support the legislation and we certainly thank Congressman Kennedy for allowing us the opportunity.

Let me add one thing. We appreciate your reconsideration, Congressman, of the 50 percent debt-to-income issue. We think that poses a real issue and we would like your consideration of that.

Chairman KENNEDY. Thank you very much.

Ms. DONOVAN. Can I ask a question?

Chairman KENNEDY. Sure.

Ms. DONOVAN. Could you tell me what you're addressing in the Fleet situation? With the current RESPA regulations that came out, wouldn't that take care of a great number of the issues that came out in the Fleet situation?

Mr. MARKS. No, it would not. It would definitely not, because you have to deal with the holder in due course. The purchasers of those mortgages have to be held——

Ms. DONOVAN. What about the excessive fees that were involved in most of those incidents?

Mr. MARKS. No. I'm not an attorney, but I can tell you that with the attorneys that we have been dealing with and the lawsuits that have been ongoing, that it would not deal with those fees, did not deal with those interest rates. It did not deal with the loan-to-value and the fact that people could not afford to make those payments.

I want to say, and it's important, they should not be marginalized as just Fleet, as just in certain States, in certain areas. It's pervasive and when you look at the United Companies, there is now a very fast-growing secondary mortgage market that deals with purchasing and the securitization of very high interest rates, very high points.

So this is an issue that if you don't address it now, it's going to become a tremendous issue, even worse, later on. So it needs to be addressed with this legislation immediately.

Chairman KENNEDY. Thank you. I want to give the time over to Mr. McCandless. I just want to make one final comment to Mr.

[illegible] of the disclosure [illegible] that are contained in this legislation [illegible] after the California [illegible].

Mr. Jones. We appreciate that.

Chairman Kennedy. As I read it, you talked generally of the California situation and then sort of directed criticism at the disclosure portions of our legislation. I just wanted to let you know that a lot of this—maybe I misunderstood you. I thought that's what you were suggesting.

Mr. Jones. I was not criticizing the disclosure portions at all. As a matter of fact, we were proud that we've handled it that way. My concern was the cap that you have on annual percentage rate and the method of computation that differs from the traditional.

Chairman Kennedy. There are no caps in this legislation.

Mr. Jones. There aren't?

Chairman Kennedy. No.

Mr. Jones. Well, in order to fit the definition—

Chairman Kennedy. You might have an earlier draft. In earlier drafts, there were caps on interest rates, but we have not—

Mr. Jones. You mean there is no cap in order to fit the definition. You're not subject to a cap. You tie it indexed to a Treasury bill instrument, as I remember, and roughly [illegible] or [illegible] points above that or [illegible] points.

Chairman Kennedy. The bill sets no interest rate caps.

Mr. Jones. It's a trigger for following the definition.

Chairman Kennedy. There's a trigger—I believe it's [illegible] points, isn't that right?

Mr. Jones. Yes. And now I believe you've changed it to—

Chairman Kennedy. Ten points above a comparable Treasury bill.

Mr. Jones. And we would like to see that increased. I was anticipating that at one time you would reconsider.

Chairman Kennedy. Wouldn't that qualify as usury rates under almost every State?

Mr. Jones. Yes. In California, the voters in 1979 made a decision and voted massively in favor of exempting loans arranged by licensed real estate brokers from the existing usury limit of 10 percent.

Chairman Kennedy. But didn't that have to do with—what were the interest rates in that year?

Mr. Jones. The prime rate was running 17 to 18 to 19 percent.

Chairman Kennedy. About [illegible] percent or something like that, sir.

Mr. Jones. Prime rate.

Chairman Kennedy. I'm not playing a game with you. I'm trying to let you know we understand what was going on in 1979 in this country.

Mr. Jones. The law is still in effect, though, Mr. Chairman.

Chairman Kennedy. I appreciate the fact that the law is still in effect. What I'm trying to suggest is where usury laws exist in this country, wouldn't the legislation that we have here qualify if there were lenders that were violating our standards, they would be violating usury rate standards in other States. Isn't that correct?

Mr. Jones. That's true. I'm sure that's true. By the way, I don't [illegible] a quarrel with that concept at all.

Chairman KENNEDY. Thank you. Mr. McCandless.

Mr. JUDIS. But I would like to say one thing in response to what the gentleman spoke to earlier. Mortgage loan brokers in California are subject to licensing laws and they have to report every year an annual report showing their activity, foreclosures, loans made, APRs, points, and so forth. It's a rather stringent report.

In 1991, the report showed that 129,081 loans were arranged by licensed mortgage brokers in California. Only 1,699 resulted in foreclosure. That's roughly 1.3 percent.

Chairman KENNEDY. Which year was that?

Mr. JUDIS. It was 1991. That was the last report year that's now on record that we have. That was 1991. By the way——

Chairman KENNEDY. But isn't the national failure rate something like 5 percent or something like that?

Mr. JUDIS. I really don't know what the rate is. I know it's considerably higher than 1.3.

Chairman KENNEDY. I looked into this issue on another question just recently and I had discussions with FNMA and Freddie about what their mortgage failure rates were, and they were indicating to me it was on average around 4 or 5 percent.

Mr. JUDIS. Well, here's——

Chairman KENNEDY. So I appreciate the fact that you had 1.3 in the State of California in that particular year. I would suggest that given what real estate values have done in the State of California in the last 3 years that maybe that rate has grown substantially since you last checked.

Mr. JUDIS. I don't have the current figure, but I can tell you that in our own company, it has gone up slightly. We'd be happy to get you a report, by the way.

Chairman KENNEDY. Whatever. I mean, come on.

Mr. JUDIS. Sorry.

Chairman KENNEDY. Two plus two.

Mr. JUDIS. Two plus two is four. That's what I'm counting.

Chairman KENNEDY. Still equals four, right. Mr. McCandless.

Mr. MCCANDLESS. I think the point that Mr. Judis is trying to make, and I'm not trying to speak for him, is that in that particular year, he was trying to give you a percentage ratio of foreclosures irrespective of the economy.

If I understood your position, it's not a question of the economy. It's a question of how do the mortgage brokers function. Are they taking everybody's home? When you have that kind of a ratio, it doesn't appear that they're functioning in that way in 1991 in California.

Mr. JUDIS. That's correct.

Chairman KENNEDY. If you're directing your comment to me, Mr. McCandless, I didn't think I suggested that——

Mr. MCCANDLESS. No. I was making a statement. I was making a statement, Mr. Chairman.

Chairman KENNEDY. The mortgage brokers were doing that.

Mr. MCCANDLESS. Mr. Judis, I'd like to kind of capsulize what it is you are in the way of a mortgage broker. For example, does your business differ from a mortgage broker in Illinois? Then what about the sources of your funds, are they the same or are they different?

Mr. JUDIS. Mr. McCandless, I really don't—I'm not familiar with the Illinois law and it would be really wrong for me to try to comment on something I'm not knowledgeable about. I don't know what the licensing laws in the State of Illinois are and I don't know whether they use private investors there or what.

Mr. MCCANDLESS. In general, would you say that if we went through 49 other States, we might find 49 other ways by which mortgage brokers are required to conduct their business?

Mr. JUDIS. Yes. It seems to be the case. We've opened offices recently ourselves in both Nevada and now in Colorado and the licensing situations in each of those States is far different than California.

Mr. MCCANDLESS. How about the sources of funds?

Mr. JUDIS. The sources of funds seem to be similar. As the gentleman pointed out earlier, there is more securitization going on in our industry. Our company is doing that more. But we have found that by being able to do that, we're actually being able to lower interest rates and costs to borrowers because we're operating more efficiently, and that's creating a much healthier and competitive environment in California.

Mr. MARKS. If I can respond, we are a nonprofit——

Mr. MCCANDLESS. It's not a response. I'm questioning the gentleman. What would be the average term of a borrower?

Mr. JUDIS. The average loan that we're making now in our company is running between 10 and 15 years.

Mr. MCCANDLESS. What would you say the average interest would be on that?

Mr. JUDIS. The average interest right now is running about 9.5 percent, 9.75 percent.

Mr. MCCANDLESS. That contract would have a balloon on it or not?

Mr. JUDIS. No. Less and less loans are being written with balloons because, frankly, the public, frankly, doesn't want balloon payments to the same degree that they did in past years. With securitization, we're able to write longer term loans and really provide a better product.

However, there are those folks who are unemployed and don't have an income now and need short-term loans with balloon payments to get through a very difficult financial period. So the ability to be able to write balloon payments is terribly important.

Chairman KENNEDY. If the gentleman would yield, just for clarification. The 9.75 percent did not fall under our legislation, in any event, because it wouldn't hit the trigger mechanism, which Mr. Judis earlier referred to. Second, California does have the balloon payment provision. Again, we modeled our legislation after the balloon payment——

Mr. JUDIS. We appreciate that.

Chairman KENNEDY. That already exists in your State.

Mr. MCCANDLESS. Which was an enlightened position to take.

Chairman KENNEDY. Absolutely. That's why you're from there, right?

Mr. JUDIS. [illegible]. Chairman, I'm afraid we would fall into the trigger. Mr. Ch[illegible], I'm afraid, though, in many instances, when you wri[illegible]mple, a 6- or a 7-year loan with a balloon, even

at that interest rate, if you add what California permits with a balloon payment loan under the regulated section, as much as 15 percent, then I'm afraid that you probably, even with the lower interest rate, would come up with a number that would trigger the definition or very close to it.

We're just looking for a little more room in that definitional trigger, that's all.

Chairman KENNEDY. We can talk about that, Mr. Judis. If there's some reasonable flexibility that we can provide so that we take into account interest rate fluctuations over the period of time of the loans, nobody—our intention isn't to set up a box that doesn't work here. We'll make some adjustments and try to take that into account.

Mr. JUDIS. We appreciate that very much.

Mr. MCCANDLESS. Let me ask one more question, if I may, Mr. Chairman.

Chairman KENNEDY. I'm sorry.

Mr. MCCANDLESS. A lot of our testimony talked about refinancing, refinancing, refinancing, and building a pyramid.

Mr. JUDIS. Yes.

Mr. MCCANDLESS. Give me an idea, if you could, about the number of loans that you broker that are paid off as opposed to the number that are refinanced. Would you have a figure?

Mr. JUDIS. Mr. McCandless, are you asking for the number of loans that get refinanced once they are originally made over a period of time?

Mr. MCCANDLESS. Right.

Mr. JUDIS. Probably so. My guess would be in California, in the current economy, the number is less than it was when California's economy was more vigorous, because equities have depreciated. But I would say probably 20 percent, 15 to 20 percent per year of the loans that have been written might be refinanced by the same company or by another company.

But remember that in California the average length of home ownership is probably around 6½ or 7 years and I would suspect that that's a shorter time period of the home ownership than in most parts of the country.

Mr. MCCANDLESS. If I understand correctly, we need to differentiate between your organization, which is independent mortgage, as opposed to banks and finance institutions, which are——

Mr. JUDIS. Yes. Yes, you should, I think.

Mr. MCCANDLESS. You have how many members in your organization?

Mr. JUDIS. We have close to 1,000 participants and probably 126 companies, actual companies that comprise a fair percentage of the gross business in this area done in California.

Mr. MCCANDLESS. If you were one of these bad guys and had a license to practice in California which hadn't been retrieved yet, you obviously could not be one of the larger institutions. You would have to be probably one of the smaller individuals in order to practice, which means, then, that your license could be withdrawn for due cause.

Mr. JUDIS. Absolutely. Licenses are revoked by mortgage brokers who conduct themselves in an intransigent way on a regular basis.

I have a letter with me, which I would be happy to submit to the subcommittee, if I may, from the commissioner of real estate in California who supervises this industry. He talks very specifically about hundreds of violations and the prosecution of those violations and the revocation of licenses of folks who are guilty of those violations.

Mr. McCandless. Thank you. Thank you, Mr. Chairman.

Mr. Judis. Thank you, sir.

Chairman Kennedy. Thank you, Mr. McCandless. I want to just clarify that this bill, I believe, is reasonable, as Household, Beneficial, Fleet, and others in the industry have said. The point is simply that the bill requires certain disclosures for home equity loans that are 10 points or more above Treasury notes of comparable duration, where a consumer is also paying 50 percent or more of his or her income on the loan.

Only then do we ban negative amortization, prepayment penalties, and other practices. So I think the bill really does get to the bad apples and leaves the good ones alone. That's what we're trying to accomplish here.

Mr. Judis. Mr. Chairman, in light of the recent amendments that we just saw earlier this morning, number one, we applaud the fact that those amendments were made and I believe that the issues that we have are few in number now and I don't believe that we are really that far apart.

As you mentioned earlier, if we can speak to you about a couple of those definitional issues and perhaps just a little bit about some of the assignee liability, without killing the concept or the motivation behind the bill, I think we could probably arrive at a very comfortable conclusion.

Chairman Kennedy. We'll look forward to working with you.

Mr. Judis. Thank you very much, Mr. Chairman.

Chairman Kennedy. Mr. Deutsch.

Mr. Deutsch. Thank you, Mr. Chairman. I just wanted to follow up with a couple of questions. Mr. Falk mentioned a letter from the comptroller of the State of Florida, Gerald Lewis, and his suggestion that perhaps States with sufficient consumer protection laws in the area should not be covered by the legislation.

Could you briefly discuss Florida law and how it addresses predatory lending and, also, from a consumer perspective, what that would do, what it does today and what it would do under H.R. 3153?

Mr. Falk. Sure. Florida law requires disclosures at the time of application, not delayed. We have a licensing and net worth requirement statute. We have preeducation licensure requirements. We have an unlimited unfair and deceptive trade practices section, including liability of $10,000, maybe $15,000 per transaction, fines for unfair and deceptive trade practices.

Certain problems under Florida law would require first degree felony conviction. A good faith estimate is done at the time of application and not 3 days later. We also authorize refunds by the comptroller of the State of Florida. We also have interest rate caps and usury [illegible] We also have the requirements certainly that all docu[illegible]st be signed filled in and not in blank.

Loan brokers, one of the problems that was highlighted several years ago, was outlawed in 1991 by the State of Florida. The question concerning whether Florida would be involved in some of the problems concerning this legislation, we believe that Florida law, in most instances, goes far beyond what this legislation is trying to protect and we believe that some of the flexibilities involved and some of the legislative initiatives are proper.

Our concerns deal with mostly the fiduciary issues which comes into terms of whether or not the lender should be responsible for independent, knowledgeable acts on the part of borrowers who enter into transactions with lenders. With full disclosure, full understanding, and full knowledge, borrowers should be able to complete transactions that are unusual, different, and not following the standard FNMA and Freddie Mac rules and regulations.

Mr. DEUTSCH. Regarding H.R. 3153, as it is presently drafted, how do you feel that addresses the problem of the predatory lending?

Mr. FALK. It addresses the problem, I believe, because it deals with some of the abuses in the marketplace. The abuses, as heard this morning, are real. They're not imagined. Florida law addresses some of these issues. We, as an association, both nationally and within the State of Florida, agree with a lot of the programs and prohibitions involved, including the disclosures.

Our position paper goes into great detail of what we can support and what we'd like to see major changes incorporated in.

Mr. DEUTSCH. It has been discussed that there might be a prohibition on a 3-year type balloon. Could you describe in what instance why a 3-year balloon would actually be more advantageous to a consumer than, let's say, a 5-year balloon?

Mr. FALK. The traditional yield curve analysis answers that question. The longer the term of a loan, the higher the interest rate. We support the concept of prohibitions on very, very short-term interest-only balloons, where the churning cycle begins, where year after year, over and over, mortgage companies or lenders charge points and points on the refinancing action.

Limiting balloons to 3 years or greater, we believe, strikes a balance to those situations where borrowers need extensions of credit and, at the same time, need a short-term loan. FNMA and Freddie Mac require 2 years of clear credit rating. Many times, what a loan broker or mortgage lender will do is give a person 1 year to clear up his credit, 2 years to remain clean, have his credit rating in place, his employment verifications in line, with a consistent income, and then refinance into a qualifying loan.

The 3-year concept allows us to clean up a borrower's credit and, at the same time, refinance them into a conventional long-term loan with full qualification.

Mr. DEUTSCH. There is a woman here who I have not met, I know my staff has met her, who came up from Florida at her own expense, Denise Mitchell, and I believe it appropriate to mention her story.

Apparently, in her specific case, H.R. 3153 would prohibit Ms. Mitchell from getting a loan. What is her situation?

Mr. FALK. She came to my attention last week when I was speaking at the Orlando Chapter of the Florida Association. She

came up to me and said that she has a story that she would have been negatively impacted had this particular legislation gone through. Based upon her story, the details of which I'm happy to relate to you——

Mr. DEUTSCH. Please, be brief, because the chairman is being pretty liberal with my time.

Mr. FALK. She needed a business loan. She wanted to go into business. She did not have verifiable income to support the future income from the business venture, had bad credit due to some divorce problems, and was turned down, she said to me last evening, by 15 different institutions when she tried to get a business loan using her home as collateral.

With full knowledge, full disclosure, she knew exactly what she was doing and she got an amortizing loan that was not a balloon and it was not short term so she could afford to make the payments. That loan would have been prohibited because she could not prove verifiable historical income to justify the new business venture.

Mr. DEUTSCH. So someone who wanted to borrow, who was conscious, who was an adult being able to make their own decision would not be able to get that loan to enter that business under this legislation.

Mr. FALK. We believe in the firewall concept, that if you separate the home improvement builder, the scam artist who inflates the price of home improvements from those who are involved in the financing, you've gone a long way to solving the problem.

Chairman KENNEDY. If I could just have a point of clarification here. Our legislation, as I understand it, requires the lender to verify income, but it does not require you to not make the loan. You can make the loan, but you have to verify their income.

Now, if there are other trigger mechanisms with regard to hitting the 50 percent or the interest rates on the loans and those kinds of things, that's a different set of circumstances. But don't try—I don't think it's right to try to indicate that Denise isn't going to qualify because of some other provision versus the provision, as I heard your testimony, that is just simply verification.

Why would we possibly want to not understand what somebody's income was before you made them a loan?

Mr. FALK. I support your position, Mr. Chairman. The problem is when you look at three or four statutory provisions together, verifying the income by the creditor.

Chairman KENNEDY. OK. What's the other one?

Mr. FALK. And then entering into a home equity loan where there is no reasonable probability that the homeowner will make a payment.

Chairman KENNEDY. OK. Is that unreasonable?

Mr. FALK. Unfair and deceptive trade practices, put together, there would be no way for a lender to verify, based upon a business venture or personal needs, that she could be able to pay back those payments. I can't look into the future——

Chairman KENNEDY. Why would you possibly give her the loan, then?

Mr. MARKS. Could I please respond to one thing? We've been down in Florida. We've been doing the research on Metropolitan

and we've been contacting people who have gotten a Metropolitan mortgage. It's unconscionable that you're sitting up here saying that you're against these things when you did lend to people who couldn't make those payments back, and that's what the *Miami Herald* is going to do a story on.

The fact of the matter is let's be serious. We have to cut off—if this does not pass on the threshold issue of whether someone can pay, then you shouldn't be able to get money from either FNMA or the securitization or other people who are funding your operations. It should stand on whether it's a legitimate loan or not.

That's why this legislation is important. It holds everybody accountable and it's a burgeoning industry that has to be stopped, with only the credible people in it. We are, as a nonprofit, a mortgage broker and 90 percent—and 95 percent of the mortgage brokers out there are legitimate. We should say the ones that are not legitimate should not receive outside funding to fuel their operations.

Mr. DEUTSCH. Let me reclaim my time for a second. I guess that's the philosophical issue that you talked about earlier. What happens when inflation becomes 15 percent and then, at that point, people want to borrow at 20 percent? Hopefully, that won't occur at any time in the future, but I think all of us can recall when it was close to that.

In terms of the lender, having been an attorney in real estate practice, the transaction costs to foreclose alone, especially in a Florida residential situation where it's very difficult, I know that a variety of protections are built into Florida law.

Can you give a sense of how much it actually costs to foreclose, Mr. Falk, as well as the percentage of loans that you actually foreclose?

I think what's important for people to understand is you're not in the business of foreclosing. That's not what you want to do. You want to lend money and have people pay you. When you foreclose—I mean, you want to keep your foreclosure rate, my understanding is, as low as physically possible.

Mr. MARKS. Can I respond to that, as well?

Mr. DEUTSCH. Let me just let him respond to those two points in terms of that, both cost and also percentage.

Mr. FALK. Costs of foreclosure in Florida, which is a judicial State of foreclosure, not statutory, run anywhere from $2,000 to $3,000. The time period can be anywhere from 6 months to 3 years. Our foreclosure rate is sitting at approximately 1.5 percent of our portfolio of nonconforming loans.

Mr. DEUTSCH. When you calculate time value of money, how much does it add up to? You're adding that and then you have a significant increase.

Mr. FALK. It is a significant increased cost.

Chairman KENNEDY. The gentleman's time has expired.

Mr. JUDIS. Mr. Chairman, if I may just make one remark about the verification of employment and verification of income streams. I absolutely understand where you're coming from on that. But in California recently, for example, we've had huge layoffs in aerospace and defense, as I'm sure you're aware.

A classic example is the aerospace engineer who comes in. He is now out of work. He's got a house paid down to maybe $3,000 and he's been told all these years to build an equity in his house because it was a great investment most of those years.

No bank will touch him because he's not working any longer. At this moment in time, he has no income. He wants to borrow on his house. A traditional lender, a depository-oriented lender cannot make him a loan. Worse, his credit may be failing and he may be behind on his existing payments.

Should he not be able to borrow? Should he be forced to sell the roof over his head to get the equity out of his house?

Chairman KENNEDY. I just want to clarify to people he can still do that. We don't say that you can't make the guy the loan.

Mr. JUDIS. But what happens——

Chairman KENNEDY. You can still make the guy the loan.

Mr. JUDIS. But aren't we exposing ourselves a little bit to the criticism after the fact where someone comes forward and says you shouldn't have made me the loan, you knew I couldn't pay it back; therefore, we're going to restrain you from foreclosing and we're going to say you didn't use prudence.

Chairman KENNEDY. It sounds to me——

Mr. JUDIS. But it happens, Mr. Chairman. It happens.

Chairman KENNEDY. Wait a second. We're not preventing you from making the loan.

Mr. JUDIS. I understand that.

Chairman KENNEDY. We're creating a set of circumstances where ...'re asking you to confirm what the fellow's income is. Now, it ...ns to me that whether or not Mr. Smith or Mr. Jones out there, ...o you've just described, is in this circumstance when you end up ...eclosing on that fellow's house——

... JUDIS. It can happen.

... rman KENNEDY. If you end up foreclosing on that fellow's ... d he comes and says you should have never loaned me the ...ey to begin with, he's going to be able to say that whether our ... was in existence or not. You're telling me that you are oppos... this legislation because of the fact that somebody might lose ... r house that had no income that you made a loan to because ... it after the fact come and say you shouldn't have made me ...

...r. ...CANDLESS. If the gentleman will yield.

... KENNEDY. Sure.

...r. ...ANDLESS. Mr. Judis now becomes liable under the

——

... JUI ...

... us because he went ahead and loaned ... had no means of paying back the ... is ...titled to all of the various and sundry ... n, even though that house might have a ...

... the fact of the matter is if you're lending to ...ay——

... CANDLESS. Are you part of the staff or are you testifying? ...is

Chairman KENNEDY. He's a witness that I called up, Mr. McCandless. Mr. Marks, did you have a response?

Mr. MARKS. Excuse me. Thank you.

Mr. MCCANDLESS. We've got a witness list here and all of a sudden somebody shows up.

Chairman KENNEDY. That's right and that happens to be the privilege of the Chair. When you get the majority, you can have the same privilege. Mr. Marks.

Mr. MARKS. Thank you very much, Mr. Chairman. If someone is lending on purely the equity in the home with no consideration of someone's ability to pay, it is your responsibility. You should not be making that loan. I can't believe that any of the mortgage brokers that you have would—that you would say to them lend purely on the equity in someone's home with no—without the consideration of their ability to pay, because the only reason for doing that is because you want that home and you want——

Mr. JUDIS. Absolutely not true.

Chairman KENNEDY. Hold on.

Mr. JUDIS. Absolutely untrue and, frankly, unfair.

Mr. MCCANDLESS. Mr. Chairman, I don't know what Mr. Marks has been smoking, but he better quit smoking it.

Chairman KENNEDY. Al, you don't have to get personal here. Let's just go back to what this legislation does. It creates a set of circumstances where if the consumer has an interest rate of 10 points above the current T-bill rate, if they also are paying 50 percent or more of his or her income on the note, then and only then do we ban negative amortization.

What we are talking about here is simple disclosure of income so that the lender has some idea of what the income of the individual is. It does not prevent you from making a loan under the circumstances that you described.

Now if that is a risky loan and if, in fact, you choose to go ahead and provide that money under these circumstances, then you are going to be taking a risk that we are describing to you up front. There's a lot of people that have fallen prey to unscrupulous lenders that have utilized this same circumstance to take people's homes.

Believe me, you say that doesn't happen. It happened in my district to over 200 homes.

Mr. JUDIS. It does happen on occasion. There's no question about it.

Chairman KENNEDY. So all we're trying to do is say, listen, there are abuses that can take place in these circumstances and we're trying to bracket against them. Can you describe a circumstance where some one individual, whether it be Deborah or whether it be this fictional individual that you described, might be in some way denied the opportunity for credit because——

Mr. JUDIS. Yes.

Chairman KENNEDY. Of the protections that we're providing a whole other group of people? I suppose that might be true, but we're trying our best to make certain that we are not preventing a lender from making a loan under those circumstances. We're just simply saying that if you go ahead and make those loans under those circumstances, you better be darned careful that you know

what you're doing. That is what we are attempting to accomplish here.

You can get bogged down in a lot of rhetoric, but that is what we are attempting to do. Most people, when they look at this legislation, think that it works.

Mr. JUDIS. We appreciate what you're trying to do here. Stopping the abuse is absolutely in everyone's interest. But by the same token, that aerospace engineer who's got that equity in that house and who is now unemployed deserves the right to borrow on his equity and we don't want to inhibit that right. That's all.

Chairman KENNEDY. And he can borrow on his equity.

Mr. JUDIS. With some difficulty, perhaps.

Chairman KENNEDY. Mr. Drent, you had a comment you wanted to make.

Mr. DRENT. Yes. I just wanted to comment on foreclosures. We're hearing percentages of actual foreclosures, and they sound pretty low, but I would suggest, sir, that most people are living under the threat of foreclosure, particularly the senior citizens. These are people who pay their bills. As Ms. Robins said, they go without to make sure they pay that bill.

Also, many people are selling their homes before they're foreclosed upon, using the proceeds of the sale to pay off the loan, losing all the equity they built up in their homes. Others are also signing deeds in lieu of foreclosure. So there is no recorded foreclosure. There's just a transfer of the property.

I guess I think it's just an incorrect focus to say we only foreclose on 1.5 percent of the loans because that really doesn't show what's happening.

Chairman KENNEDY. Thank you.

Mr. DRENT. Also, the caps are floating.

Chairman KENNEDY. Thank you very much, Mr. Drent. If Mr. Deutsch or Mr. McCandless have a final comment.

Mr. MCCANDLESS. Yes, Mr. Chairman. I apologize to the gentleman. I got carried away here, but he's evidently lost a couple of chapters in this book that he's been writing, because people who have equity in farms, people who have equity in cars, people who have equity in all kinds of things, not the least of which is a house, are able to borrow based upon their past history of how they paid when they were not employed.

If I'm a farmer and I lost my crop and this is the second time I lost my crop and I still have a little equity left in my property, I can go get a loan to put another crop in. At some point, if I keep losing my crops, then I no longer own the farm or the ranch or whatever you wish to call it.

This is standard. Let's take this defense engineer, for example. He's got a son in college or he's got something here, he's got something there, and it's time to pay the tuition and he knows within the next 6 months or so that he's going to go back to work because he's been told by somebody just as soon as we have this or that, whatever the circumstances are.

But in the meantime he has to support his obligations and he goes wn to a traditional finance institution. They, basically, under rules and regulations that they work under, cannot loan y ıy money that is unemployed. That's where I'm coming

from. And there's nothing wrong with that because it's happening in thousands and thousands of cases and has happened for years and years in California.

That's why I got all excited.

Mr. MARKS. Sir, I appreciate that. If I can just make one quick comment. We give extra protection around real estate issues, because it's such a fundamental issue. We're talking about a fringe element that is becoming more and more mainstream. If someone is desperate and they cannot—and that they lose their job, they don't have the income, we should look at the motivation of the lenders who are lending them money.

Is that motivation because there is a legitimate credit need out there or is that motivation because there's a lot of equity in that house, they want to get the highest interest rate and, in the end, they want the home? In our experience, and we've had a lot of experience in this area, with all due respect, is that there's a lot—there are all the lenders out there that want to get that return quickly, know people cannot make those payments and want the equity in the home. That is what we're concerned about. Those loans should not be made, sir.

Mr. MCCANDLESS. Mr. Marks, where you have that kind of a situation, we're in parallel. But you shook your head when we talked about the engineer and you said we should not loan that person money. That's why I came unglued. Thank you.

Mr. MARKS. Thank you.

Chairman KENNEDY. Thank you, Mr. McCandless. Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman. Again, I guess there really is a philosophical difference. I think there's a certain point where I don't think the government ought to really be dealing with motivational analysis of people in terms of why they want to tap their equity.

I have some personal experience in the real estate world and borrowing on real estate and transactional real estate. The people who are in the lending business are in the lending business. They don't want to lose money and they don't want to foreclose.

It's a business of lending. You're dealing with people who can make their choices, who have information, and I don't believe you meant to take away that freedom. People have the freedom to lose their homes, in that sense. I don't think we ought to deny the person who is making $100,000 a year and loses his job and wants to take risk capital out of his home.

Some people might feel otherwise, but I just don't.

Mr. MARKS. Sir, I'm sorry. I just wanted to say one thing. Since you are an expert in real estate or you have that experience, you know that if there is 40 percent equity in the home, in the past, people have not looked at people's ability to pay. We think that that is preying on people's desperation. If you go up and you look at where Metropolitan or other finance or brokerage companies lend, it's in the minority and working class communities. It's targeting people who are the most vulnerable.

That's why what this legislation does is protect the most vulnerable from their major assets.

Mr. DEUTSCH. Let me just respond. One is I just don't think because people are poor or minorities, they're ignorant or they don't

have the ability to make their own decisions about whether to borrow money on their homes or not. That's number one. You don't need to protect them. They can protect themselves.

Number two, I'm not saying there are not abuses in the system. There clearly are abuses and there are people who ought to be in jail and some of them are in jail. But that's where we're drawing the line. I think Mr. Judis said it best in his last statement, that we support—and I have been very supportive of what the chairman is trying to regarding Fleet scam—I'm aware you've been very successful in dealing with what these con artists.

That's what we should be focusing on, not trying to stop people from tapping their own equity when they know and they're knowledgeable about what they're doing.

Mr. JUDIS. May I just say one thing? There are also thousands of business——

Chairman KENNEDY. We could just keep this baby going for as long as we want. I think everybody has got the point. There's a few lines drawn in the sand. I just want to say for the record that none of these provisions even caused any kind of controversy really in passing the Senate. We look forward to getting a bill out.

Thank you all very much for your testimony. I appreciate it. Seeing no further questions, on behalf of the subcommittee, I want to express my appreciation to all our witnesses who shared their stories with us today. I'd like to ask unanimous consent that the record be kept open for a period of 4 weeks from today so that additional views may be submitted.

Hearing no objection, so ordered. The panel is excused and the subcommittee is in recess.

[Whereupon, at 1:34 p.m., the hearing was recessed, to reconvene at the call of the Chair.]

A P P E N D I X

March 22, 1994

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ONE HUNDRED THIRD CONGRESS

ROOM 604 O'NEILL HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

Opening Statement
by
Representative Joseph P. Kennedy II (D--MA)

March 22, 1994

THIS MORNING, THE SUBCOMMITTEE HOLDS ITS SECOND HEARING ON THE SERIOUS PROBLEM OF HOME EQUITY LENDING ABUSE. THIS IS A PROBLEM THAT IS NATIONAL IN SCOPE. IT AFFECTS PEOPLE OF ALL BACKGROUNDS -- WHITE AND BLACK, URBAN AND RURAL. TENS OF THOUSANDS OF HARD-WORKING FAMILIES HAVE BECOME THE UNWITTING VICTIMS OF SCAM ARTISTS AND PREDATORY LENDERS. THEY HAVE WORKED THEIR ENTIRE LIVES TO FINALLY OWN THEIR HOMES -- ONLY TO LOSE THEM TO UNSCRUPULOUS LENDERS HELL-BENT ON EXPLOITING THEIR AGE OR LACK OF FINANCIAL KNOW-HOW. IN MANY CASES, THEY HAVE LOST THEIR SAVINGS, THEIR HOMES, AND THE PEACE OF MIND THAT THEY EARNED THROUGH YEARS OF SWEAT AND TOIL.

THIS SUBCOMMITTEE, AS WELL AS THE SENATE BANKING COMMITTEE, HAS COLLECTED OVERWHELMING EVIDENCE OF SHOCKING ABUSES TAKING PLACE THROUGHOUT THE COUNTRY. WE HAVE SEEN CONSUMERS PAYING 20, 30, EVEN 40 PERCENT FOR HOME EQUITY LOANS. WE HAVE SEEN CONSUMERS WHO ARE SQUEEZED INTO PAYING 25 PERCENT OR MORE OF A LOAN JUST IN FEES AND COSTS. AND WE HAVE SEEN CONSUMERS LOSE THEIR HOMES DUE TO THE HIDDEN TERMS IN A LOAN THAT ARE THE HALLMARKS OF THESE MORTGAGE SCAMS: BALLOON PAYMENTS, NEGATIVE AMORTIZATION, PREPAYMENT PENALTIES, AND REFINANCING AT HIGHER AND HIGHER RATES.

OUR FIRST WITNESS TODAY, MARGE ROBBINS, WHO LIVES JUST A COUPLE OF BLOCKS FROM ME IN BRIGHTON, MASSACHUSETTS, IS JUST ONE OF THE THOUSANDS OF HOMEOWNERS IN MY STATE WHO BECAME TRAPPED IN A SPIRAL OF DEBT BY UNSCRUPULOUS LOAN SHARKS. AT ONE POINT, SHE WAS SUPPORTING HER DISABLED -- AND NOW, I'M SORRY TO SAY, DECEASED -- HUSBAND, AS WELL AS HER DEVELOPMENTALLY DISABLED SON, ON AN INCOME OF $2563 PER MONTH -- AND PAYING $2150 OF THAT AMOUNT FOR A HOME EQUITY LOAN. THAT'S ABOUT 84% OF HER INCOME. IF THAT ISN'T LOAN SHARK UNDERWRITING, I DON'T KNOW WHAT IS. ALL TOLD, SHE WAS FORCED TO REFINANCE 11 TIMES -- EACH TIME PAYING THOUSANDS OF DOLLARS IN PREPAYMENT PENALTIES, BROKERS FEES, AND OTHER OUTRAGEOUSLY INFLATED COSTS.

H.R. 3153, THE HOME EQUITY PROTECTION ACT, WAS INTRODUCED TO MAKE SURE THAT WHAT HAPPENED TO MARGE ROBBINS DOES NOT HAPPEN AGAIN TO ANY AMERICAN HOMEOWNER. ITS GOAL IS SIMPLE: TO CURB THE ABUSES IN THE HOME EQUITY MARKET, WITHOUT CURBING THE ABILITY OF THAT MARKET TO PROVIDE VALUABLE FINANCING TO CONSUMERS.

SINCE INTRODUCTION, I HAVE CONSULTED WITH MEMBERS ON BOTH SIDES OF THE AISLE. I HAVE ALSO HEARD FROM SEVERAL RESPONSIBLE INDUSTRY MEMBERS WHO ACKNOWLEDGE THAT ABUSES IN THE MARKET MUST BE STOPPED. A NUMBER OF CONSTRUCTIVE SUGGESTIONS HAVE BEEN PUT FORWARD, WHICH I BELIEVE WILL IMPROVE THE BILL'S ABILITY TO MEET ITS GOAL. IT IS MY INTENTION TO OFFER THESE SUGGESTIONS IN AN AMENDMENT WHEN THE SUBCOMMITTEE MARKS UP THIS LEGISLATION. AMONG OTHER REVISIONS, THIS AMENDMENT WOULD:

-- RESTRICT THE BILL TO ONLY CLOSED-END CREDIT TRANSACTIONS;
-- ALLOW BALLOON PAYMENTS ONLY AFTER 6 YEARS;
-- ALLOW REFINANCINGS WITH THE ORIGINAL LENDER ONLY WHERE THE INTEREST RATE ON THE NEW LOAN IS LOWER THAN THE RATE ON THE ORIGINAL LOAN;
-- EXEMPT CREDIT INSURANCE FROM THE FEES CONSIDERED UNDER THE BILL;
-- LEAVE UNTOUCHED THE FEDERAL PREEMPTION OF INTEREST RATES FOR THESE TYPES OF LOANS;
-- EXEMPT REVERSE MORTGAGES; AND
-- REQUIRE A DEBT-TO-INCOME RATIO OF 50% OR MORE TO TRIGGER THE PROHIBITED PRACTICES OF THE BILL.

I WANT TO PARTICULARLY THANK CHAIRMAN FLAKE, MR. LAROCCO, MR. FIELDS, MR. WATT, MS. FURSE, MS. ROYBALL-ALLARD, AND MR. KING FOR THEIR INPUT. I ALSO WANT TO RECOGNIZE THE CONSTRUCTIVE ROLE

PLAYED BY HOUSEHOLD INTERNATIONAL, BENEFICIAL MANAGEMENT, FLEET FINANCE, AND AARP. THESE ORGANIZATIONS HAVE ALL WRITTEN IN SUPPORT OF H.R. 3153 AS I WOULD HOPE TO AMEND IT. COPIES OF THEIR LETTERS ARE ON EACH MEMBER'S DESK. I WOULD ASK UNANIMOUS CONSENT THAT THESE LETTERS BE MADE PART OF THE RECORD.

THESE CHANGES WILL NOT ERODE THE FUNDAMENTAL CONSUMER PROTECTIONS OF THE BILL. ON THESE, THERE CAN BE NO COMPROMISE. FIRST AND FOREMOST, CONSUMERS WILL HAVE TO GET FULL DISCLOSURE OF THE RISKS OF HIGH-COST HOME EQUITY LOANS -- INCLUDING NOTICE THAT THEY COULD LOSE THEIR HOME, AND MIGHT BE ABLE TO FIND A CHEAPER LOAN. SECOND, THE BILL PROHIBITS LENDERS FROM TAKING ADVANTAGE OF A CONSUMER'S AGE, LACK OF FINANCIAL KNOW-HOW, OR PHYSICAL AND MENTAL INFIRMITIES. THIRD, THE BILL ASSIGNS LIABILITY FOR THESE LOANS TO THE MAINSTREAM LENDERS WHO OFTEN BUY THEM. UNDER THIS PROVISION, THESE LENDERS WILL NO LONGER BE ABLE TO WASH THEIR HANDS OF THE FRAUD AND DECEIT USED BY THE BROKERS OR FINANCE COMPANIES WHO MAKE THE LOAN IN THE FIRST PLACE. FINALLY, WHERE CONSUMERS ARE PAYING MORE THAN 50% OF THEIR INCOME FOR A HIGH-COST LOAN, THE BILL OUTLAWS THE PRACTICES THAT ARE MOST OFTEN USED TO ROB PEOPLE OF THEIR MONEY AND THEIR HOMES. THESE PRACTICES INCLUDE BALLOON PAYMENTS, NEGATIVE AMORTIZATION, PREPAYMENT PENALTIES, AND REFINANCINGS AT HIGHER RATES.

I AM HOPEFUL THAT, WITH THESE CHANGES, WE CAN BRING A WELL-BALANCED BILL TO CONFERENCE WITH THE SENATE. IT IS CRITICAL THAT WE ACT TO STOP THE MORTGAGE SCAMS THAT HAVE TURNED THE AMERICAN DREAM OF HOME OWNERSHIP INTO A NIGHTMARE FOR TENS OF THOUSANDS OF FAMILIES.

Opening Statement of

Congresswoman Lucille Roybal-Allard

Subcommittee on Consumer Credit

March 22, 1994

Mr. Chairman, I would like to thank you for holding this hearing to discuss H.R. 3153, the Home Equity Protection Act.

Mr. Chairman, as you know, home equity fraud is a daily occurrence for those who cannot rely on mainstream lenders to obtain credit. One hundred cases of home equity fraud are reported in Los Angeles each month. Across the nation, people who have worked all their lives to own their homes are being stripped of their life savings and made homeless by usurious lenders out to make money off the backs of the

poor. This tragedy demands Congressional action.

Fraudulent lenders have developed a successful niche for themselves by preying upon communities that have historically been redlined. As we speak, some unscrupulous, smooth-talking, scam artist is going door-to-door convincing homeowners in my community to take out loans they can never realistically repay.

Mr. Chairman, I look forward to working with you and the Members of the Committee to put an end to this illegal and immoral practice of home equity fraud. I also look forward to finding some common ground to ensure that this legislation does not penalize legitimate consumer lenders or create a credit crunch for those who already find difficulty in obtaining credit.

Thank you.

COMMENTS OF MARJORIE ROBINS
ON
H.R. 3153 -- THE HOME EQUITY PROTECTION ACT OF 1993

Hearing before the
Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance, and Urban Affairs
House of Representatives

March 22, 1994

Chairman Kennedy and Members of the Committee, thank you for your invitation to testify today.

My name is Marjorie Robins of 11 Priscilla Road, Brighton, MA 02135.

I live there with my 28 year old developmentally disabled son who lives on the 3rd floor. He helps with the mortgage payments from his disability check and also works in a workshop and contributes between $150 and $175 a month additional income.

I work part-time as a cafeteria worker for the City of Boston, School Department at a middle school and work 20 hours a week (sometimes more) at a rate of $8.20 an hour before taxes, usually getting $164.00 a week.

My husband Gary was a self-employed cab driver who leased a cab until he had part of his foot amputated prior to his serious illness. Gary made about $150 a day driving a cab 12 to 14 hours a day. He was not allowed to go back to driving a cab after

having his foot amputated, seriously hampering the amount of income we had.

We also get rental income of $800.00 a month plus my social security check for a total income every month of $2,563.00 less than half of what we got before Gary took sick and passed away.

We paid off our original mortgage in 1983. We originally purchased our house in 1968, for $28,500.00. We refinanced a small remaining balance in 1983 because the City of Boston Inspectional Services had us do repairs to the house to bring it up to housing code.

Unfortunately, we called a company named Financial Enterprises in Canton, Massachusetts. The first loan we got from them was to fix up the house. It was at a rate of more than 16%. Right away they began to call and send advertisements asking us to refinance. During the course of years we refinanced to put up new storm windows, fixed porches, gutters, roof, painted, caught up on back taxes, and caught up on excessive water bills. We also refinanced for medical reasons when Gary, my husband, took sick.

Altogether we refinanced 11 times. No one ever told us that each time we refinanced, they were charging us a penalty to pay off the old loan. We also did not see that they were charging attorneys fees of many thousands of dollars for the refinancings.

(We found out later that these attorney fees were going to the president of the company-- he was the company attorney.) In June of 1990, we also found out by accident that Financial Enterprises had had us sign a refinancing agreement that included a quick claim deed in Financial Enterprises' name which meant that we did not own the house, that Financial Enterprises did and the only way we could get it back was to pay off the entire mortgage.

We were contacted by a number of mortgage companies and finally settled on Century Mortgage who told us we could get an F.N.M.A. mortgage at 8 1/2%. We were told that we were eligible for this until 2 days before the signing when we were suddenly told we had to pay an interest rate of 16-38% for a total of $2,150.17 a month for 15 years. My husband and I never signed the original application. A copy of tha papers can be sent for your review. We were told we were eligible for the lower rate if we supplied all the forms required which I did. Later, we were told that with my husband in the hospital, that we no longer qualified for the lower rate because the house needed some outside repairs and therefore had to take the higher rate. We were also not told that the would be sold to a company in California -- Advanta Mortgage. For the closing, my husband left the hospital in a wheel chair, connected to an intravenous line in his neck and we conducted business in the hallway of the mortgage company's lawyer, because there were no handicapped facilities.

We had to pay off all other creditors before Century would give us the money. These included a car loan, a small personal loan, several small credit card balances, plus repayment to Financial Enterprises of $113,000, including a penalty charge for paying off the loan before it was due. The loan also included a $6,000 payment to a company called Equitystars which had arranged the loan. (We only learned later that Equitystars was the same company as Century Mortgage, they have the same address.) We ended up with $165.99 in cash as part of the amount financed. Needless to say, we fell behind in the payments of $2,150.17 immediately because of my husband's illness. He was in the hospital 2 1/2 months with a massive infection in his left foot and ended up having toes amputated in November.

I contacted Advanta Mortgage, to whom Century Mortgage had sold the loan, and explained the situation to them and offered to pay between $1200 to $1500 a month for a period of time until my husband got back to work. They would not accept this. They said pay the whole thing or nothing. They threatened to foreclose. I contacted them again in January, 1991, and in February, 1991 and the answer was still no.

My husband and I contacted attorney Robert Novack of Fall River, Mass. and he suggested that I contact the mortgage company again and try to work out something. We were refused, and in September 1991 we filed for bankruptcy in order to hold off a foreclosure. Their attorney contacted us and told us that our

house was going to be sold at auction November 8, 1991. The bankruptcy action put a hold on it and that's when Colonial Bank, who now had the mortgage -- filed for relief of the stay. We went to court with Mr. Novack on November 15, 1991 and the judge told us to try and work out an agreement. He also felt that our mortgage was exceedingly high.

We then went back to court to see the trustee, Mr. Joseph Szabo to file a plan. We were told that Colonial Bank of California and been tendered a plan to refinance the mortgage of $144,000 with interest of 11 1/2%, to make the payments approximately $1500 a month, plus $200.00 a month to Mr. Szabo for some small bills which also had been included in the bankruptcy petition. The bank refused and we were unable to submit a plan for the bankruptcy court. We were in a very bad situation and needed someone to help us rewrite our mortgage.

I tried everything to calling the bank -- appealing to their mercy -- calling a personal counsellor by the name of James Allen who referred me to Attorney Leon Aaronson, who has since been disbarred. We filed bankruptcy a second time and this held off the bank for a short time. Needless to say, we have spent quite a bit of money on lawyers, legal fees, etc. (..money which I took from heating expenses, eating, etc.) Till this day, I have to watch my expenses and there were many cold days this past winter. We went without heat so our mortgage was paid, and we

had food on our table. My house means everything to me and I will not go through anything like what happened ever again.

We were told about another organization, the Victim Resolution Program run by the bankers in Massachusetts, but they turned us down as they did not want to deal with an out of state bank. They referred us to Norma Moseley and Ecumenical Social Action Committee in Boston who took us in hand. Thank God for them. Norma had me contact a lawyer who contacted Advanta Mortgage and threatened them with a lawsuit. More legal fees, though, and more money involved. We had to send Advanta Mortgage in May of 1992 $3000 or more, I'm not sure of the figure, to hold off foreclosure. They gave us 2 months to come up with some sort of payment plan.

Needless to say we did not know what we were going to do. I scraped together the money and got a 2-month extension. That's when Norma and Regina went to work. They contacted Shawmut Bank who had the house reappraised and we found out the value of the house had gone down. The appraisal we had received in September of 1990 was for $302,000. Shawmut said 2 years later it had gone down to $200,000. The City had another appraisal for tax purposes. When all was finally realized, it would take a minimum of $161,000 to buy back our house, which was sold while we were sitting in it one day in July of 1992. We never even knew the sale was taking place. Sitting here writing this, I cry knowing

now destitute and lost my husband and I felt — deserted and helpless.

Shawmut Mortgage refinanced our mortgage by buying back our house, paying my taxes, gas bills, water bills, electric bills, etc., which had mounted during the 2 year fight we had to hold onto our house.

I thank God for people like Norma Moseley and her staff at MSAC who helped us. We now have a mortgage of $1317.58 a month, which includes principal, interest and taxes. The toll it took on me was indescribable. I lost my husband even though our mortgage and bills were paid off. He just gave up the fight in December of 1992. He went into a coma and died on May 9, 1993. I myself sit here and cry and hope this story will help keep another family from going through what we did.

Testimony of the

NATIONAL CONSUMER LAW CENTER

before the

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE

of the

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

regarding

H.R. 3153

THE HOME EQUITY PROTECTION ACT OF ~~1993~~

March 22, 1993

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COMMENTS OF THE NATIONAL CONSUMER LAW CENTER[1]
ON
H.R. 3153 -- THE HOME EQUITY PROTECTION ACT OF 1993

Hearing Before the
Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance, and Urban Affairs
House of Representatives

March 22, 1993

Chairman Kennedy and Members of the Committee, thank you for your invitation to testify today.

The National Consumer Law Center is an organization which acts in part as a national support center for legal services attorneys and pro bono attorneys representing low-income consumers around the country. Hundreds of attorneys from all over the country routinely request our help in analyzing credit transactions and determining what legal rights and remedies their clients might have.

We had the honor of appearing before both this subcommittee and the Senate Banking Committee while the members explored the heart-rending problems of families losing their homes to predatory lenders, particularly in low-income and minority areas ignored by market-rate lenders. In those hearings, we were able to draw on our experience of examining hundreds of these mortgages and share what we have learned about their most common techniques. We also discussed why, for the first time, high rate lending became a substantial threat to people's homes.[2] High-rate lending has been around for a long time, but not until recently were people threatened with foreclosure because of it. Mortgage loans, the most secure credit, were not generally subject to outrageously high costs -- until the last decade: foreclosure rates have increased by more than *200%* since 1980, and these loans are no small part of that problem. This testimony will not repeat the explanation for the shift, (which includes deregulation), but that background is important to keep in mind as we think about ways to protect family homes from the excesses of greed.

[1]These comments were prepared with the assistance of Gary Klein, Margot Saunders and Robert Hobbs.

[2]*See* Problems in Community Development-Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, *Hearings before the Senate Committee on Banking, Housing and Urban Affairs*, 103rd Cong., 1st Sess. 256 (1993)(statement of Kathleen Keest). [*hereafter, Sen. Hrngs.*]

THE LAW AGAINST "STEALING HOME"

Today, we are quite pleased to be back to discuss H.R. 3153, a step in the right direction. This should be viewed as the law against "stealing home."[3] While it is not a total fix -- we should not delude ourselves about that[4] -- it is progress. H.R. 3153 was a creation of compromise from its birth; and any further weakening will just reduce its effectiveness as a solution to the problem of equity-skimming and loss of homes. We are particularly pleased that it substantively limits some of the more egregious practices, rather than relying merely on disclosure. While disclosures are helpful, they cannot be the answer. The recent Department of Education study indicating that 40% of adult Americans are functionally illiterate highlights the ineffectiveness of a public policy of "borrower beware," (with or without disclosures) in the area of complex credit transactions, which these loans are often designed to be.[5]

THE PEOPLE AFFECTED

As you consider this bill, we urge you to keep in sharp focus the people who will benefit from this bill. People like my former neighbor, who had to drop out of school in the fourth grade to help care for the family; older people, who came of age in an era when you trusted that people were trying to do right by you; responsible and credit-worthy people who have been ignored by market rate lenders -- too often minority homeowners.[6] (The lopsided demographics on these loans make it clear that this should be viewed as a fair lending law for minority and elder homeowners.)

We also urge you to keep in sharp focus the lenders who will -- and won't -- be affected by this bill. As Eugene Ludwig, Comptroller of the Currency, indicated in his Senate testimony, this legislation, deterring creditors who want to charge excessive fees and interest, and impose repayment terms the consumer cannot meet, *will not interfere with legitimate*

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[3]The term was used by reporter Mike Hudson, *Stealing Home: How the Government and Big Banks Help Second Mortgage Companies Prey on the Poor*, 26 Clearinghouse Rev. 1476 (March, 1993) (*reprinted with permission from The Washington Monthly*).

[4]In our Senate testimony, we suggested that one of the most critical reforms would be the reinstatement of rate ceilings and limitations on other charges. In that, we felt that the experience of the last "deregulation" decade only proved that the previous 2000+ years of laws against usury were right after all. *Cf.* Senate Hearings, p. 393 (statement of John B. Long).

[5]*See* "Literacy of 90 Million is Deficient," Washington Post, p. 1 (Sept. 9, 1993).

[6]As prior hearings revealed, the evidence increasingly mounts that race skews the lender's perception of creditworthiness, to the detriment of minorities. On the flip side, those mortgage loans which are being made in minority and low-income neighborhoods under CRA programs are, for the first time, being evaluated and found to perform as well -- and in some instances, better than -- traditional loans to non-targeted borrowers. See "Sound Loans For Communities: An Analysis of the Performance of Community Reinvestment Loans," (Woodstock Institute, October, 1993).

financial transactions. H.R. 3153 is narrowly tailored to target the problem lenders, not home equity lending in general. It is critical to keep that in mind as you hear comments and criticisms about the bill. For instance, balloon payments in home equity loans generally are not prohibited. Only balloon payments in high-cost loans are prohibited. That's a big difference. Not all refinancing lenders are limited in their right to impose points on the new loan. Only high-cost lenders are so limited. Please do not lose sight of that as you are asked to weaken this bill.

H.R. 3153 goes a long way toward protecting the most vulnerable from the loss of their home to those who look only for maximum profit -- at others' expense. While we are very pleased that the Senate has now passed a companion (though weaker) bill, we urge that H.R.3153 go forward as written, for it closes some important gaps in the Senate bill.

COVERAGE OF OPEN-END CREDIT

One provision of H.R. 3153 as introduced is particularly crucial to close a major loophole left in its Senate counterpart, S. 1275. The definition of a high cost mortgage in the Senate excludes open-end credit. The Senate committee report explained that its hearings "produced no evidence of abusive home equity loan practices in the open-end credit market."[7]

There are many problems with that. First, there is predatory open-end credit. Attached to this testimony is an open-end home equity loan from a nationwide finance company. (Exhibit 1) According to our information, this loan product invariably results in a large balloon payment. Yet because it is cast as open-end credit, that is not clear to the borrower.

The example in Exhibit 1 had a credit limit of $56200, yet the initial advance was $57200. This variable rate contract, initially at an 18% rate,[8] provided for monthly payments of 1.5% of the account balance. ($858.37 at the outset.) It also included credit insurance premiums which began at $48.62/month, and grew from there along with the outstanding loan balance. There was also a $50 annual fee on the plan.

Very unobtrusively, (see if you can find it[9]), there is a provision calling for the loan to terminate in 15 years. NCLC amortized this loan, assuming the initial rate on this ARM would *fall* to 15% in 1 1/2 years, and then remain there. *The 15-year surprise to the debtor is a $66,487 balance to pay off, after already paying $163,743 over the years*!

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[7]S. Rep. No. 103-169, 103rd Cong., 1st Sess., p. 23.

[8]There was an origination fee of $1405, as well.

[9]In a slight understatement, it also mentions that the minimum monthly payments (of $858 and higher) will not fully repay the loan in 15 years.

This was not disclosed as a balloon payment, since under TIL, payment schedules are not a required "open-end" disclosure. Also not required open-end disclosures are the total of payments ($230,230), the total finance charge ($138,241), nor the total credit insurance premiums ($9,327). (Undoubtedly, the less-informative disclosure requirements of open-end credit played a role in the creditor's decision to structure the loan this way.)

The second flaw in the logic of excluding open-end credit from this bill is that predatory lenders will simply seize this loophole, and this practice of disguising closed-end credit will grow. As noted above, there already is one incentive to create spurious open-end credit; exclusion from this law would add an even more enticing one. There is no point in allowing more people to lose their homes to foreclosure before you have to pass more legislation to plug the gap -- not when we know very well right now it will happen.

THE TRIGGER

The trigger is the mechanism by which this bill targets the problem loans. The ultimate compromise in this legislation is that it still permits these loans to be made at all: the narrower the net cast by the trigger, the more problem loans will remain free of its strictures, to wreak financial havoc on its victims and threaten them with loss of their homes.

The Index: The first prong of the trigger covers loans with APRs higher than 10% above the 1-year Treasury index, while the Senate bill uses Treasury securities of comparable maturities. As the Senate report notes, a 1992 survey found that the average spread over the 1-year Treasury rate for home equity loans was 4.36%.[10] Thus using the 1-year rate captures those loans with spreads already *twice* the going rate, but use of a comparable maturity rate would allow an even wider gap before the protections of this bill kick in. Use of the one-year rate would now capture loans at 13 1/2% APRs,[11] while on a 5-year loan, loans with APRs up to 15% would escape. Given the availability of 7% 5-year second mortgages now, there is absolutely no justification for increasing the allowable spread any further.[12]

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[10] S. Rept., *supra.* note 7, at 24. The average 1-year Treasury rate for 1992 was 3.89, so a rate of average spread over that would be 8 1/4%.

[11] Table I.35, 80 Fed. Res. Bull. A26 (Feb., 1994). (Figures for Nov. 26, 1993).

[12] A quick survey of Boston rates on 5-year closed-end seconds showed a range of rates from 7% - 9.6%. (The higher rate was from only one institution surveyed, and it was coupled with a low teaser rate.) Adam Smith himself thought that the legal interest rate ought not be much above the *lowest* market rate. The Wealth of Nations, Chap. 4. (quoted by John B. Long, Consumer Credit Actions: High Rates, Racial Discrimination and Other Suits, p. 4, Conference Materials, National Consumer Rights Litigation Conference (NCLC, Oct. 1992).

The 8% Trigger: The second prong of the trigger is extremely critical, as, if not properly covered, it can be a serious loophole. It provides an alternative test for coverage of loans with fees of more than 8% of the amount financed, minus fees.[13]

One of the most frequently used techniques of equity-skimming lenders is to pad loans, not only with a very high number of points, but also with a vast array of other charges, some for legitimate services, some for highly questionable ones, but most often "padded" far beyond a reasonable price.

The bill purposely did not look solely to 8% of the "amount financed" as that term is defined by Truth in Lending for the reason that TIL, on real-estate secured lending offers a number of loopholes that these lenders have exploited to the hilt. Among charges which, *on their face*,[14] are permitted by TIL to be included in the amount financed are:

brokers' fees
credit insurance premiums
lenders' attorneys fees
separately imposed (and inflated) charges for numerous "services".

Here are three examples from NCLC files of how the amount financed can be artificially inflated with charges:

* *Broker's fees:* Broker's fees of $6000, more than 10% of the principal on a 19+% loan, financing a home solicitation sale of windows. (The thoughtful broker called back within 3 months, and offered to get the homeowner a lower rate: 17.5% on another loan, with another $6000 broker's fee.)

* *Credit insurance:* Of an amount financed of $20,238.66, the consumers received only $9,241.22. Nearly $11,000 of the amount financed represented credit insurance premiums, *much of which represents additional lender profit, in the form of commissions.*

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[13]There is a technical anomaly in the draft, in that it says "8% of the amount financed, minus fees and points." Under Truth in Lending, points are never part of the *amount financed*, 15 USC § 1605(a)(1), though they are routinely included in the *note principal*. That is why, for example, the interest rate on a promissory note from Landbank Equity would be 15% or 18%, while the APR would be 28%. The 25 - 40 points charged by that company were counted as part of the note principal, but not part of the TIL amount financed. Assuming the lender complies with TIL, the points would be captured by the APR, but many fees would not.

[14]For some of the common fees, TIL rules provide that they can be part of the amount financed where they meet certain conditions. E.g. Reg. Z, § 226.4(c)(7), § 226.4(d), § 226.4(e). The reality is that these lenders virtually always treat them as though they do meet those conditions, and so the fees are not treated as part of the finance charge. Consequently, they are not captured in the APR.

* *Closing costs:* A California second mortgage shows the lengths to which some creditors go in creating closing costs with which to pad the amount financed. This contract is reproduced as Exhibit 2.

The "amount financed" was $10,403.51, of which the consumer got only $7500. The lender deducted from the amount financed the following closing costs, which comprise more than 26% of the amount financed:

$350.00	appraisal fee
489.90	loan processing fee
5.00	notary fee
27.50	credit investigation fee
189.90	loan disbursement fee
325.00	document preparation fee
400.00	underwriting fee
142.12	fire insurance premium[15]
60.00	beneficiary statement fees
20.00	recording fees
450.00	costs of investigating or guaranteeing title
40.00	request for notice
247.50	interim funding fee
2746.92	

(Incidentally, this lender charged 21 points, too. The note rate was 12.5%; the APR disclosed was 23.5%, but even that does not capture the above $2746 in fees, which is equal to another 21 points.)

As it happens these particular examples would meet the trigger in any event. However, they show dramatically how easily manipulated, and misleading the "amount financed" can be. A $50,000 amount financed may include $3950 in brokers fees, insurance premiums, or closing costs, (well in excess of the norm), and nevertheless escape the trigger. If the 8% trigger looks solely to the TIL "amount financed," one will see even more lenders exploiting the laxity of TIL rules in order to hide additional profit.

THE SUBSTANTIVE PROHIBITIONS

The primary significance of H.R. 3153 as introduced lies in its substantive prohibitions. The bill, in its critically important unfair and deceptive practices provisions, makes it clear that equity-theft, by whatever imaginative devices may be created, is *not* a

[15]The first mortgage payment already included an insurance and tax escrow.

legitimate business. Moreover, it deprives equity-skimmers of some of the most common tools they have used to date in their efforts to transfer wealth from the poor to the predatory.

Through price-gouging on the credit -- the interest rates far in excess of market rates, high origination fees, inflated fees, exorbitant brokers fees to related entities, prepaid penalties -- the pay-back on these loans grows far out of reasonable proportion to the lender's actual investment. (And, of course, the lien on the house grows in the same unreasonable proportion.) Such tools, which make a loan obligation grow by smoke and mirrors, often work together to grossly inflate the debt.

There is no countervailing pressure on high-cost lenders to be concerned about loan performance. Despite the record foreclosure rates, home-secured lending is still the most secure, so this is virtually a no-lose game for these lenders. They have no incentive to pay attention to any underwriting beyond the value of the house. Either the inflated loan will repaid by the borrower's heroic efforts (too often sacrificing other needs such as medical care or jeopardizing a previously current first mortgage), through refinancing (usually to wind up deeper in trouble), or, at worst, the creditor gets the house through foreclosure. The creditor can buy it at a distress price (claiming the value of the grossly inflated lien), and resell it at market prices

In the following discussion of the substantive prohibitions, we will attempt to show briefly how these tools work, and why they must be forbidden.

Balloons: This is one of the most insidious tools of these lenders. Balloon provisions make sense in only certain circumstances, such as when the borrower has a lot of liquid assets from which to pay it (these victims don't); when the borrower plans on -- and is fairly certain he can -- sell the home and make the payment from the proceeds (most of these victims want to stay in the home); or as a bridge to longer-term, affordable financing (that isn't the way these loans play).

In the vast majority of these loans, there is no way homeowners can meet the balloon. Consequently, they will default, or will desperately seek refinancing, which too often simply drives them deeper in debt, either with the same creditor, or another scam creditor or "foreclosure specialist." If the borrower was aware of the balloon at all, the creditor may well have made oral (and usually fraudulent) assurances that it would be refinanced.

* A borrower, facing a balloon from one scam lender, was solicited by the broker for a second scam lender to refinance that balloon. (The first lender had alerted the broker, in what could be likened to a game of hot potato.) She resisted as long as she could, hoping to sell the property herself at market value, and use her equity (about $80,000) to relocate. The broker told her the rate would be 20%, and she could get additional funds for repairs to make resale easier. But the $139,000 loan was at 22% (actually, it was 35%, but they didn't tell her that), included a $4170 origination fee, a $1000 document preparation fee, and a $10,000 broker's fee (the first she'd heard of

that.[16]) She got additional money in the new loan all right -- $16,500, but she saw only $400 of that. Oh, and by the way, it, was a one-year balloon.

The monthly payments were $2550, substantially in excess of her monthly income. Since it was inevitable that she couldn't meet the monthly payments, the default provisions were interesting: a 1% of the unpaid principal and interest balance each month ($140 the first month), AND a new default interest rate of 42%. (And there were substantial prepayment penalties, too, which could have ranged from $7600 to as much as $14,600. Those were due upon involuntary prepayment, as in the case of foreclosure.)

The impact of all of this of course, was to swell the already huge balloon even further -- there was no equity left at all. She tried to commit suicide when she learned that.

* A couple in their 60s borrowed approximately $30,000 on a 20 1/4% loan. The principal, however, included almost $12,000 of a "prepaid payment escrow, inflating the balloon due in two years to $44,600+. With no liquid assets, and only about $1000/month income, there was no way of meeting that. Because this loan included so much padding, the principal on any new loan -- even if refinanced at a lower interest rate -- would have been an extraordinary drain on their income.[17] Hence default was inevitable.

It should be noted that for these default-inducing balloons, it makes no difference whether the balloon comes due at the end of 1 year or 6 years or even 15. (...except that the borrower has poured far more money down the drain in that time.) A homeowner who borrowed at age 66 will find it no easier to face foreclosure at age 72 or 82 than he could at 67. The open-end contract described earlier, Exhibit A, is a classic example of why *for these high-cost loans, balloons must be totally forbidden.* That homeowner, who borrowed $57,000, would make $163,000+ in payments, and *15 years later* still owe a balloon payment that is $9000 more than he borrowed.

Another reason why balloons on these high-cost loans must be forbidden is that, irrespective of when they are scheduled to come due, they dangle like Damocles' sword over the homeowner's head, driving them into ever more expensive refinancing. And, as will be discussed later, refinancing one of these high-cost loans is no boon to the borrower.

Prepayment penalties: Prepayment penalties are a trap. As they are drafted in high-cost loans, the borrower gets hit coming, going, or staying put.

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[16]In fact, the broker and the lender were essentially the same entity.

[17]A ten-year, 12% loan on that principal would have monthly payments of nearly $640, which would be almost 64% of the couple's monthly income, if memory serves.

* The consumer who recognizes the problem with a high-rate loan and tries to refinance at market rates has an inflated pay-off, and, consequently, higher costs on the market rate loan. Exhibit 3 shows a 24.9% loan (and a 29+% APR) with a prepayment *penalty of 29% of the original principal for the first 3 years*, gradually reducing to 20% at 8 years. If this borrower tried to get out of this 29% loan to replace it with a market rate loan at 12 months, his pay-off would inflate from $11,115+[18] to $14,361+. (Notice that the prepayment penalty also applies in the event of default and foreclosure, inflating the value of the lender's lien.) The penalty on the borrower doesn't stop with the $3000-larger pay-off to the old, high-rate lender. Even a 10%, 5-year refinancing will cost the borrower $69/month more because of the inflated pay-off.[19]

* The first balloon example described above included prepayment penalties which could be imposed upon foreclosure and could increase the amount owing by $7600 to $14,600. ("3 month's interest at the rate then in effect," which, remember would have been 42% anytime after the inevitable 1st payment default.)

* Exhibit 4, our example of the flipping penalty, shows what happens when prepayment penalties are combined with other tools for loan inflation. By repeatedly soliciting refinancing from the borrower, (7 loans in 3 years) and imposing prepayment penalties on the old-loan pay-off and new charges on the new loan, the borrower paid $85,410.14 over 39 months for $48,629.97 proceeds. That's the equivalent of a 38% rate, though all of these loans had APRs of 16.5% - 18.5%. The monthly payments grew from $310.54 to over $1000 -- more than 60% of the borrower's income.

Negative amortization: The open-end mortgage, Exhibit 1, is a good example of the insidious impact of negative amortization, whereby the debt grows even if all payments are made as scheduled, because the payments do not cover accrued interests and costs. There is no legitimate reason to justify a loan which has a homeowner shelling out $167,000+ over 15 years on a $57,000 debt, only to still owe $66,000 -- almost $9300 more than was borrowed!

Prepaid payments: The prepaid payment limitation stops one of the smoke-and-mirrors loan padding techniques the more imaginative high-rate lenders used to skim more equity out of borrower's homes. We call it the prepaid payment pyramid.

* Homeowner wants to borrow $24,000. This 24% lender writes a one-year $40,000 balloon. But instead of scheduling 11-interest only monthly payments and one balloon, the lender created an escrow of the equivalent of 12 interest only payments,

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[18]The copy of the note is hard to read, but it appears that the note principal is $11,194.00.

[19]A 5-year, 10% loan of $11,115 would have monthly payments of $236.16. A 5-year, 10% loan of $14,361 has monthly payments of $305.13.

and withheld it from the proceeds ($9600).[20] The impact of this on the real cost? Compare a $40,000 1-year lump-sum pay-off on a $24,000 principal for 1 year, which is an effective rate of 66.67% APR.[21]

Limitation on fees upon refinancing: Where the same (or affiliated creditor) refinances a high-cost mortgage, they are prohibited from imposing points on the refinanced balance. Because points are considered earned at consummation, a creditor can grossly inflate its "earned" income by imposing a high origination fee (points) on loans likely to be foreshortened by refinancing or other kinds of prepayment.[22] Unlike regular interest, the lender keeps all the points irrespective of whether the loan goes to maturity or not.

In its most simple form, the spiral works like this:

* Loan # 1 -- A borrower needs $5,000. At 15%, her monthly payments will be $146.76, which is fine with her. Indeed, 15% is the interest rate specified in the promissory note, but the stated principal is $6169, not $5000. The lender has capitalized (treated as principal, not interest) 19 points in drafting the note and making the calculations. The lender's total compensation for that $5000 loan is $3805.60: $2,636.60 "interest" (15% for 5 years on the proceeds <u>plus</u> points), plus $1169 (19 points). (The APR on this loan, for Truth in Lending purposes, would be 25%.)

Loan # 2 -- To see how that affects the borrower, assume the loan is refinanced after 24 months. If Loan # 1 were treated simply as a $5000, 25% loan, the lender would have *earned* $2213.22 in interest; but with 19 points, treated as a $6169, 15% loan the lender will have earned $2755.86 ($1586.86 in regular interest, plus the $1169 in points). Thus the pay-off on Loan # 1 is over $540 more because of the points charged on it.[23]

<u>Now</u>: since the points are calculated as a percentage of the new principal, that inflation of the pay-off spirals up the amount of dollars charged as points on Loan # 2.

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[20]There was also extra $6000 padding in other forms, including points, a 9% broker's fee, higher than usual attorneys fees, and some unusual other additions, like "will preparation."

[21]One might ask whether the fact that the borrower didn't have to come up with monthly payments have some value. Think of it this way: a 24%, $24,000 one year balloon would have cost $29,760. So that "favor" cost the borrower $10,240. For another example of the prepaid payment pyramid, see *Therrien v. Resource Financial Group*, 704 F. Supp. 322 (D.N.H. 1989).

[22]*See* National Consumer Law Center, Usury and Consumer Credit Regulation § 5.2.2.1 (1993 Supp.).

[23]The effective interest rate the borrower paid on her $5000 for those two years was thus 29 1/2% when the impact of the points is considered.

Now: add the impact of any outrageously inflated closing costs in Loan # 1, which also are not rebated. Consider the loan in Exhibit 2: were that loan refinanced, not only would the new points charged be calculated on a principal which included the unrebated 21 points on the old loan, but also on those old inflated closing costs which, as it happens, equal a *second* 21 points.

Now: add the impact of prepayment penalties added to further inflate the pay-off on the refinanced loan. (See e.g. Exhibits 3 & 4).

The new percentage-based charges imposed on the now-inflated principal of Loan # 2 thus have themselves grown dramatically. Now: flip that loan several times, repeating the process each time, and the lender increases the debt tremendously even if the borrower gets very little -- or no -- new money. Such flipping games are how 16% - 18% loans, such as those in Exh. 3, can really give a lender a 38% yield. And so it goes...

UNFAIR AND DECEPTIVE PRACTICES:

We feel that the UDAP provisions in H.R. 3153 are among the *most critical and necessary* provisions in the bill. The reality is that greed can trigger the imagination, and limiting specific things will undoubtedly mean that other ways to achieve the same end -- stealing equity -- will be devised.

Making unaffordable loans and taking advantage of the vulnerable as unfair practices: The examples given in this testimony show clearly how -- and why -- these loans are made without regard to the ability to repay. And we know who the victims of these lenders are: those unable to protect themselves, or who have no choice because of the failure of the market to offer them one.

Some have argued that these provisions are "too vague" to be workable, and will simply encourage litigation. The provisions which declare making "bound-to-fail" loans and taking advantage of the vulnerable to be unfair and deceptive practices are particularly singled out. But these provisions are critical, because they go to the very heart of the matter. The purpose of this bill is to stop the equity-theft that has been perpetrated mainly against the most vulnerable homeowners in our society. To delete those provisions would be like criminalizing assault with guns, but not criminalizing the act of assault itself. Smart muggers would simply start using lead pipes.[24]

These two provisions are by no means radical, nor are they too vague and unworkable. In fact, *they are taken from model legislation regarding unconscionable conduct which has*

[24]The general prohibitions of (g)(5) and (8) also have the same purpose.

been on the books in 13 jurisdictions for years.[25] I think the Committee would be hard-pressed to find anyone who does -- or legitimately could -- claim that those states have experienced either a loss of credit because of those provisions, or a clogging of the courts. The law has been on the books in Iowa for 20 years; in my 10 years of practice there, I saw no evidence of its creating a problem for either the courts or legitimate creditors.

Brokers fees: Brokers who steer borrowers to high-cost lenders bear a great deal of responsibility for this problem. The brokers have a financial stake in getting a bad deal for the borrower. (Often they are really acting as the "bird-dog" for the lender, or they may simply be following the financial imperative of "reverse competition."[26] At times, the broker and the lender are actually the same people.)

As is clear from our earlier examples, these brokers also usually charge far more than the standard -- we have seen 6 - 10% of the loan principal as fees. Often the borrowers did not know they were dealing with a broker -- they thought the broker was the lender -- and did not know of the existence of, or the whopping size of -- the brokers' fee until closing. This would stop that practice by requiring that the broker and borrower have previously entered into a contract spelling out the fee: no more $6000 surprises at closing.

Assisting in the falsification of information on the application for a loan: Loans where the monthly payment is 90% of income -- or more -- often are the result of brokers or originators who simply lie about the borrower's income.

Disbursing home improvement contractor funds: Many of these loans are financing home improvements, often to contractors who go door-to-door, and do shoddy, incomplete, or no work at all. Some of these contractors also are little more than bird-dogs for the lender, and the lender will release the money to the contractor before the work has been done. There is no incentive for the contractor to complete the job, or to do it well.

PERMITTING STATES TO REGULATE HIGH-RATE LOANS:

Fourteen years ago, Congress preempted state usury ceilings on residential first liens, an overbroad solution to a temporary problem:[27] purchase-money mortgages were hard to

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[25]According to CCH Consumer Credit Guide, such provisions are found in some form in the District of Columbia, Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Ohio, Oklahoma, South Carolina, West Virginia, Wisconsin (taking advantage of infirmities only) and Wyoming.

[26]When a broker's fee is a percentage of the loan principal, he gets a bigger fee from a principal padded with a lot of points and charges than from one that isn't.

[27]The Depository Institutions Deregulation and Monetary Control Act of 1980, 12 USC § 1735f-7a. (DIDA)

get because of an unusual mismatch between the aberrantly high market rates and existing mortgage ceilings. Similarly, AMPTA[28] overrode state protections against balloons, negative amortization, and other non-rate protections, to unleash "creative financing" techniques so that people could pursue the American dream of homeownership.

But, unlike this bill, neither DIDA nor AMPTA were narrowly targeted to address the problem at hand. The result was 30% first liens to finance used car purchases, and high-rate mortgage companies which require pay-offs of low-rate firsts so they can take an unregulated first. Their overbreadth has meant that states which wish to provide their citizens with a measure of protection -- and may wish to provide them with more than this bill offers -- are unable to do so. There was no need for non-purchase money firsts to be included within the sweep of preemption when it happened. The experience of the past decade has made that clear, and it is time to correct that error.

ASSIGNEE LIABILITY:

One of the most frustrating experiences for homeowners and their advocates -- and the cause of much cynicism about the fairness of our judicial system -- is the Holder in Due Course Doctrine. A consumer may have legitimate claims and defenses to forestall a foreclosure on a high-rate mortgage. They may constitute either a complete defense, or they may considerably reduce the debt to a manageable amount, thus enabling the consumer to remain in the home.

Yet, if the originator sold the loan on the secondary market, the lender trying to foreclose may say, "that's none of my concern -- your money or your home." The imbalance of moral and legal responsibility in the contractual relationship created by this doctrine is most devastating, and cannot be justified.

Among other reasons it can't be justified is that if it were the borrower's washing machine at stake -- it couldn't happen. If it were the borrower's used car at stake -- it couldn't happen. The FTC's Preservation of Claims and Defenses Rule,[29] in effect for 19 years would protect the consumer. But the home -- more important, more valuable, and more difficult to replace -- that's a different story. It shouldn't be. Equally unfairly, if the home might be lost as the result of a home improvement contract, the FTC rule may protect the consumers.[30] But if the home might be lost as the result of a home equity loan taken out to pay a hospital bill, the FTC rule does not protect the consumer.

[28] The Alternative Mortgage Transaction Parity Act, 12 U.S.C. § 3800. (AMPTA)

[29] 16 CFR § 433.

[30] It applies to the purchase-money financing of goods and services, but not to straight loans.

H.R. 3153 simply codifies the FTC rule, as it has been interpreted, and extends it to high-cost mortgages. Like the FTC rule, though, it balances the interests of the assignees and the consumer. The consumer can raise legitimate claims and defenses, which may be a complete defense, or may reduce the debt. However, the assignee's liability is limited. It can never lose more than the value of that contract. (And, contrary to some misimpressions, it can't be liable for more than the originator.)

Example: How The Assignee Liability Provision Works

The consumer has made $10,000 payments on a debt, and has an outstanding balance of $15,000 at the time a foreclosure is filed. The consumer raises defenses and counterclaims which the court finds to be legitimate, and is awarded damages of $30,000.

*If it was the **originator** foreclosing*:

- the foreclosure would not proceed, because $15,000 would be setoff against the outstanding balance,

- the originator would write a check for *$15,000* to the borrower to pay the remainder of that $30,000 damage award.

*If it was the **assignee** foreclosing*:

- the foreclosure would not proceed, because $15,000 would be setoff against the outstanding balance,

- the assignee would write a check ***$10,000, the return of payments made***. The assignee's liability is limited to that.

- the borrower cannot collect the remaining $5000 of his $30,000 judgment, because of the assignee's limited liability protection.

Just as was the case with the FTC rule, this not only restores the fairness and balance to the contractual relationship, but it has a beneficial impact on the market. The holder rule is, in part, responsible for the extent of the current problem: the originators have no incentive to be responsible when they can dump these contracts on the secondary market, and the assignees have no incentive be careful about who they do business with when they can insulate themselves from claims and defenses to the loans.[31] But with this provision, though an assignee's liability is limited, it presumably still would prefer not to have to answer for another's wrongs. Hence it encourages self-policing in the industry.

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[31]Sen. Hrngs., 314.

Finally, it should be noted that assignees can -- and commonly do -- protect themselves from loss in these circumstances by including recourse provisions in the contracts of assignment. Such provisions require the originator to compensate the assignee for any such losses.

CONCLUSION:

For over a year now, Congress has been hearing of the heartrending stories of those who became entangled with these lenders. H.R. 3153 is by no means a step too far, but rather just a step closer to controlling the excesses of the last few years.

Statement of

Robert F. Elliott

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Office of the President
Household International, Inc.

at the
Hearings on

H.R. 3153, "The Home Equity Protection Act"

on

March 22, 1994

before the

Subcommittee on Consumer Credit and Insurance

of the

Committee on Banking, Finance and Urban Affairs

U.S. House of Representatives
Washington, D.C.

Mr. Chairman and Members of the Committee, I am Robert F. Elliott. I appreciate the Committee's invitation to testify today on H.R. 3153, the Home Equity Protection Act.

I am testifying on behalf of Household Finance Corporation (HFC) which is one of several finance and banking business units operating within our parent holding company, Household International, Inc. (HI). I joined Household in 1964 and I have been involved in the consumer finance business in various capacities for my entire career.

HFC's Business Profile

HI is a publicly-owned financial services company with assets of $32.5 billion. We offer a broad range of financial services and products to consumers and small businesses. Our company employs more than 15,000 people and we serve approximately 13.3 million customers in the United States, Canada, the United Kingdom and Australia. HFC is the Company's oldest and largest subsidiary and one of the Company's three core businesses.

HFC offers a variety of secured and unsecured products to its customers through a network of approximately 470 branch offices located in 36 states throughout the country. While HFC's business is conducted primarily through state-licensed companies, its lending products are subject to extensive federal laws and regulations relating to discrimination in credit extensions, use of credit reports, disclosure of credit terms, and correction of billing errors.

Since its founding 116 years ago, HFC has been recognized as a leader among finance companies in responding to the changing needs of its customers with innovation and creativity. The Company was the first to set interest rates below the legal maximum and to offer loans through mail solicitation. We also introduced the monthly payment plan; worked in concert with the Russell Sage Foundation to create the first state regulation of the consumer finance industry;

and created the Money Managers Institute to educate consumers to make informed financial decisions. HFC pioneered the development of revolving lines of credit so consumers could borrow money in the amounts and at the times that best fit their needs. We today continue our commitment to providing our customers with value, innovation and leadership by initiating new marketing efforts to serve inner city communities through our Urban Support Project and by establishing a Hispanic Division within HFC to serve communities that are underserved by other financial institutions. We actively encourage community involvement because it is our view that consumers and HFC working together can create a better future for the community.

Home equity legislation is of great importance to our company. Household International is a major player in the home equity market. On an owned, managed, or serviced basis, our consumer loan receivables portfolio exceeds $43.0 billion as of the end of 1993. The total amount of home equity loans HFC managed at the end of 1992 was $6.7 billion, while the gross receivables of Household Bank for its second mortgage portfolio was $1.4 billion.

Reverse Redlining Practices are Unconscionable

Over a year ago, this Subcommittee held its initial hearings on the subject of reverse-redlining and specific types of abusive credit practices. Heartbreaking testimony was heard about the results of credit practices of certain second-mortgage lenders and third-party originators who targeted poor and working class consumers and who charged above-market interest rates and/or add-on loan fees. There was also testimony about other types of questionable business practices that take advantage of individuals who are inexperienced in credit matters. There is no defense for these practices. I truly regret to acknowledge that for many reasons, some consumers are indeed victimized by certain credit grantors. The consequences of these practices can be that, in

extreme cases, consumers lose their homes.

Last March, Chairman Kennedy and Ranking Minority Member McCandless both gave me the opportunity to meet with them and to explain that, as unconscionable as the practices uncovered by your hearings were, they are not standard business for our Company nor the many other lenders with whom we compete. I indicated to both Mr. Kennedy and Mr. McCandless that HFC was willing to work with the Members of the Subcommittee to correct the abuses caused by a few. I, therefore, appreciate the opportunity to testify before you today on H.R. 3153 and more specifically a "manager's amendment" which Chairman Kennedy has indicated he hopes to offer at the same time the Subcommittee marks up the bill.

Senate Activity

Consistent with our work with the Members of this Subcommittee to address the problems connected with reverse redlining, we also sought the opportunity to work with the Senate Banking Committee in their development of legislation. As you know, the entire Senate just last Thursday enacted H.R. 3474 (S. 1275), the Community Development, Credit Enhancement and Regulatory Improvement Act of 1993. I had the opportunity to testify before the Senate Banking Committee last May in support of S. 924, the Home Ownership and Equity Protection Act of 1993, the provisions of which are the basis of S. 1275. The Senate in agreeing to enactment of S. 1275 made several additional improvements in the bill that I thought were useful:

- removed the pejorative term "high cost mortgages";
- allowed prepayment penalties during the first year of a mortgage and balloon payments for loans of more than 5 years;

- removed credit life insurance from inclusion in the points and fees trigger.

Scope of H.R. 3153

H.R. 3153 as introduced by Chairman Kennedy and other Members of the Subcommittee last September was intended to address problems experienced with respect to so-called "high-cost mortgages" which have resulted in foreclosures in a number of areas throughout the country. The bill would apply to any "high-cost mortgage" as defined in the bill. Unlike the definition included in the companion legislation in the Senate (S. 1275), the definition of high-cost mortgage did not originally distinguish between, and would cover equally, "closed-end" mortgage loans, such as installment loans where the borrower is provided a single lump sum loan amount which is repaid over time, and "open-end" loans, such as those typically made by HFC through its revolving credit program, where the credit may be borrowed, repaid, and borrowed again. (§ 2(a)).

H.R. 3153 approaches the high-cost mortgage issue in five general ways. First, the bill establishes disclosure requirements which are intended to inform borrowers of the nature of, and risks associated with, mortgage loans covered by the bill. (§ 2(d)). Second, the bill imposes restrictions on certain payment terms (e.g., balloon payments and negative amortization) and fees which have been associated with such mortgages. (§ 2(d)). Third, the bill prohibits unfair, deceptive or evasive acts by lenders making such mortgages. (§ 2(d)). Fourth, the bill sets forth penalties for violating the provisions of the bill, includes state attorney general enforcement powers, and provides for assignee liability. (§ 4). Finally, with respect to mortgages secured by a first lien on residential real property which is not used to finance the purchase of the property (a so-called "nonpurchase first mortgage"), the bill repeals the preemptive effect of section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Alternative

Mortgage Transaction Parity Act of 1982. (§ 3).

HFC's Philosophy

As a business person managing a consumer-oriented finance company in today's extremely competitive financial marketplace, I would first like to provide you with some general thoughts about our competition and our customers, two of the most important variables in our economic survival.

With respect to our competitors, we believe that the great majority of them operate responsibly and with sensitivity to the human and social needs of our customers and society as a whole. We urge you to listen to them and believe that they have a number of constructive suggestions for improving the bill, particularly in their recommendations on improvements to the bill's unfair and deceptive practices section. We believe that this section should be amended to give the Federal Reserve Board authority to prohibit specific acts or practices that the Board determines to be unfair, deceptive or designed to be evasive of the Act.

With respect to our customers, the focus of HFC is on providing our customers with competent, needs-based service, which recognizes that when our customer comes to us, he or she is somewhat vulnerable and in need of assistance through difficult times.

Our franchise has grown for 116 years because we serve people who are largely denied credit from traditional lenders. Our focus today continues to be on providing credit services to borrowers whose needs are not fully or even adequately served by other financial institutions.

We believe, however, that our customers come to us not because they have nowhere else to turn, but because we offer something besides money. In this regard, open, candid, plain English disclosure of credit terms and conditions is not a burden. Rather, it is our competitive

advantage. Our strategic intention is to be a company viewed by our customers as the market leader in service quality, integrity and, thus, value. Competent, needs-based service, delivered in an open, candid manner, is what our customer values; it is what he or she is willing to pay for. We hope it is why he or she selects Household.

Support for Manager's Amendment

And this is why Household will support legislation that is based on disclosure and informed decision-making by the consumer. Although we were not able to support H.R. 3153 as it was introduced, Household now believes that the changes described in the letter sent by Chairman Kennedy inviting me to testify at this hearing can result in a piece of legislation that will allow the consumer to make an educated, informed credit decision. We believe in this; and we believe we do it now. The disclosure provisions in the bill and other provisions sketched out in Mr. Kennedy's March 17, 1994 letter should result in the elimination of the clearly egregious and indefensible practices we have heard about in hearings today and last year.

At the same time, it is our hope that the legislation described in Chairman Kennedy's letter will not curtail the legitimate uses of innovative credit products that are designed for use in the proper circumstances. This is also important, for individuals have very different credit needs at different times and the elimination of certain credit products could end up hurting many of the people you seek to help. For example, Mr. Chairman, your bill originally did not acknowledge the development of "reverse mortgages", an interesting new product that will help our oldest Americans remain in their own homes with a steady income for their twilight years. On the floor last week, the Senate amended S. 1275 with legislative language tailored to the use of this new product. Your proposed manager's amendment now also exempts reverse mortgages from

coverage by the bill, provided certain disclosures are made. This is a constructive change to H.R. 3153 that is a "win" for consumers who want this product, and a "win" for lenders like HFC that want to enter this market. I believe that there are many other areas in this bill, as well as in H.R. 1015, amendments to the Fair Credit Reporting Act, which this Subcommittee is also working on, where there are wonderful opportunities for consumers and the business community to work together.

Revision to the Original Bill

Because Household has historically reached out to customers who are underserved by traditional depository institutions, our initial reaction to H.R. 3153 was concern that its legislative remedy would potentially impose more harm than relief by jeopardizing our ability to make credit available to the modest income consumers you want us to serve, and the consumers we desire to serve as new customers. Specifically, we indicated our opposition to H.R. 3153 because it imposed arbitrary underwriting standards and interfered with the ability of home equity originators to set interest rate charges based on individual circumstances.

We outlined five major problem areas in the original text of H.R. 3153 and Chairman Kennedy, in his March 17th letter, has responded to our concerns by suggesting a number of significant revisions to the bill which he has committed to support as part of a manager's amendment.

Specifically, the problem areas identified and revisions suggested are:

- ✦ The definition of "high cost mortgage" included "open end" credit transactions. In regard to "open end" loans, the key issue of consumer disclosure that H.R. 3153 is designed to address are already largely addressed by provisions of the Truth-in-

Lending Act (TILA), as amended by the Home Equity Loan Consumer Protection Act of 1988.

Under TILA, creditors that offer open-end home equity loans already are subject to extensive disclosure requirements which were expanded under the 1988 Act. For example, under the provisions of Regulation Z adopted by the Federal Reserve Board to implement the 1988 Act, such creditors are required to provide specified disclosures on or with applications for open-end home equity loans (so-called "application disclosures"). 12 C.F.R. § 226.5b. Such creditors also must furnish to each consumer additional disclosures before the first transaction is made by the consumer under the open-end home equity plan (so-called "initial disclosures"). 12 C.F.R. §§ 226.5 (b) (1) and 226.6. Pursuant to these existing disclosure requirements, consumers already receive disclosures which, in many respects, are quite similar to those that would be required under H.R. 3153.

It is our belief, consequently, that the extensive disclosures required for open-end loans under TILA are serving consumers well and that "open-end credit transactions" should be excluded from the definition of a "high cost mortgage". The hearing records have shown no evidence of abusive home equity loan practices in the open-end market, but rather that it was closed-end, fixed rate loans (which are subject to less rigorous TILA disclosures) that were the sources of abuse. Chairman Kennedy has indicated that one section of the manager's amendment would limit the application of the bill's provisions to closed-end credit transactions since TILA disclosures do adequately provide consumers with sufficient information.

- The "trigger" for requiring the "high cost mortgage" disclosures of H.R. 3153 was any home equity mortgage with an interest rate in excess of 10% above the rate on U.S. obligations with a one year maturity. This is significantly different from the Senate bill's approach which includes only loans with an annual percentage rate exceeding 10 percentage points above the rates on comparable maturity Treasury securities. This is a pricing issue that if left in its present form would significantly restrict the flow of credit to the borrowers whom H.R. 3153 seeks to protect. Chairman Kennedy has indicated that his revised amendments will now include a provision tying the "trigger" for defining a mortgage as a "high cost mortgage" to Treasury securities of comparable maturity to the loan involved, rather than a one-year Treasury security.

- The bill also reopened the issue of federal preemption of interest rates with respect to first mortgages other than those used to finance the acquisition of the property securing the mortgage. The federal preemption, as you recall, was approved by Congress in 1980 and 1982 because state usuary ceilings were economically destroying the balance sheets of mortgage lending institutions which, during that time of rampant inflation, were forced to make loans at rates beneath their cost of funds. We hope the lessons of the thrift crisis of the 1980's would persuade Congress that subjecting the national mortgage markets to state usuary laws is not good public policy. Chairman Kennedy

has indicated that the manager's amendment will delete Section 3 of the bill, which would have repealed Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Alternative Mortgage Transaction Parity Act of 1982.

- H.R. 3153 did not originally allow any flexibility to lenders to create new products that address the needs and desires of their customers. We hoped that at a minimum the Federal Reserve Board would be given the discretionary authority to exempt specific mortgage products and categories of products such as FHA insured loans or reverse annuity mortgages. Chairman Kennedy has indicated that his manager's amendment will exempt reverse mortgages from coverage by the bill, provided certain disclosures are made, and it would be our hope that this exception could be broadened to provide the Federal Reserve Board with discretionary authority to exempt Title I and other types of HUD-FHA insured loans.

- We had reservations about the original provisions of H.R. 3153 restricting the availability of credit insurance for consumers in connection with "home equity loans" and "second mortgages". We suggested that items exempted under Regulation Z be excluded from the 8% trigger and that the Federal Reserve Board should have discretionary authority over items to be included in the trigger. Chairman Kennedy has indicated that the manager's amendment will revise the provisions of the bill to state that in determining fees and charges subject to the 8% points and fees trigger, mortgage broker fees would be included, but fees for credit insurance and other items exempted under the Federal Reserve Regulation Z would not. The Federal Reserve would have discretion, where necessary, to include items as subject to the 8% trigger. This is quite a satisfactory improvement in the bill.

Mr. Chairman, we applaud the approach you have taken in your letter of March 17. It is an approach already taken by reputable lenders -- full disclosure and fair dealing. It will protect those who need protection, but leave in place much of the flexibility needed for credit grantors to provide credit products based on the individual needs and circumstances of the individual consumer. We take great pride in the fact that our business practices are based on working with an educated consumer to fill his individual needs.

HFC wants to be the industry leader in integrity. We have developed systems and technology so that our loan documents are electronically stored and printed only as needed. Although some human error will always occur, our investment in technology helps us to

continually stay in compliance with changing regulations, and it enables us to provide our customers with up-to-the-minute, accurate information.

Need for Outreach to Underserved

To help educate the thousands of consumers who we hope to make our customers, we have available in our sales offices an "Understanding Money and Credit" booklet, which I have appended to my testimony, to answer questions and assist customers in making educated financial decisions. We are also in the process of developing additional literature to explain specific credit terms and loan features.

To reach out to new customers who are underserved by traditional depository lenders, HFC has underway an extensive Hispanic marketing effort. We have fully bilingual offices in operation today in San Antonio, Texas, San Jose, California and the north side of Chicago. Because of the success of this program, we plan this year to expand our focus to the top 25 branch offices found within the densest concentration of Hispanic populations.

We have also opened an office in the riot affected area of Los Angeles as part of our Urban Initiative Program. On opening day, people came into our new office singing our old jingle and waving decades-old HFC identification cards. As a result of its success, five other inner city offices are now on the drawing boards. One of these offices will open in May in the Jamaica section of Queens, New York. The Hispanic offices and the inner city branches are managed, staffed and supported by HFC personnel of ethnic and cultural affinity to the people they serve. We strongly believe that is a secret of our success. We also believe that diversity in the workforce must include senior management, at HFC four of our eleven senior managers are women, two of whom are African-American.

Consistent with our commitment to educate our customers on money management and handling credit, all our sales literature and documents are produced in Spanish as well as English and we have produced TV and radio public service announcements on the importance of managing credit with the noted Hispanic educator Jaime Escalante as our spokesman.

Our company operates with a philosophy of commitment to being a contributive corporate citizen in the communities we serve. Our employees are actively encouraged to voluntarily participate in public service activities and, through its "Help for Communities" program, HFC provides funding for more that 270 local community programs.

Ethical Lending Commitment

Household does not wish to take advantage of its customers. Long-lasting relationships are very important to our company and treating customers right is a good business practice. Household views service and integrity as ways to distinguish itself. We take very seriously our responsibility to conduct our business affairs in accordance with the highest legal and ethical standards. We have a Statement of Business Principles, adopted by our Board of Directors, that sets forth the principles by which we manage the businesses of the Corporation. When we discover issues of questionable compliance to these principles, we act quickly and forcefully to correct them. With respect to the abhorrent practice of redlining and reverse-redlining, our Statement of Principles says:

> "In dealing with employees, customers and suppliers, the Corporation makes decisions without regard to race, color, religion, national origin, sex, age or handicap ..."

> "In dealing with customers, Household is dedicated to offering top quality products and services and to supplying only honest information about then. Household will offer its products and services on a competitive basis and will not tolerate the use or attempted use of improper incentives to obtain business."

A copy of our Statement of Principles is appended to my statement.

Conclusion

In conclusion, as a business organization that engages in the highly competitive financial services industry, we would prefer to see group members police their own lending activities. We, of course, would have hoped that market forces would have prevailed to protect the vulnerable individuals cited throughout these and your earlier hearings. The consumer credit industry is highly fragmented with thousands of banks, thrifts, credit unions and other financial institutions competing for the consumer's lending business. We would have hoped that consumers would obtain good, solid information and would opt for doing business with those companies that provide the best value to them and that treat them honestly and fairly at all times.

However, the practices of a few lenders caused harm to real individuals and, as legislators and recognizing society's commitment to equal housing and credit opportunities, you were compelled to move in the direction of additional federal regulation of the home equity market. We support the direction in which you are moving. We note, however, that H.R. 3153 as introduced was not tightly focused and actually went so far that the customers you seek to protect would have been harmed. We ask you to keep your bill tightly focused as proposed in your "manager's amendment", and if this amendment is adopted as you have outlined, HFC will support its enactment by the House of Representatives.

Household will be pleased to continue to work with the members of the Subcommittee to achieve a bi-partisan manager's amendment, and we welcome the opportunity to work with you and community groups to close forever the sorry experience of reverse redlining. I look forward to the opportunity to answer your question. Thank you.

Oral Statement
of
Robert F. Elliott
Household International, Inc.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I AM ROBERT ELLIOTT. I AM PRESIDENT OF HOUSEHOLD FINANCE CORPORATION (HFC), WHERE I HAVE WORKED FOR A VERY LONG TIME.

I WANT TO THANK THE CHAIRMAN AND REP. McCANDLESS FOR THE OPPORTUNITY TO TESTIFY TODAY. BOTH OF YOU WERE KIND ENOUGH TO MEET WITH ME A YEAR AGO WHEN THE ISSUE OF REVERSE REDLINING BECAME A MATTER OF NATIONAL CONCERN. WE EXPRESSED TO YOU THEN OUR ABHORRENCE OF CERTAIN UNCONSCIONABLE PRACTICES UNCOVERED BY THIS SUBCOMMITTEE'S INVESTIGATION. I TOLD YOU THAT THESE PRACTICES WERE NOT THE PRACTICES OF HOUSEHOLD, AND THAT OUR COMPANY WOULD BE WILLING TO WORK WITH YOU TO CORRECT THE ABUSES CAUSED BY A FEW.

DUE TO THE EFFORTS OF THE CHAIRMAN AND HIS STAFF, WE HAVE COME A LONG WAY SINCE LAST MARCH TO TODAY'S HEARINGS ON H.R. 3153. DUE TO THE CHAIRMAN'S WILLINGNESS TO KEEP DISCUSSIONS OPEN TO ALL SIDES, IT APPEARS THAT WE ARE CLOSE TO AGREEMENT ON A LEGISLATIVE PROPOSAL THAT THE HOUSE CAN BRING TO THE CONFERENCE DELIBERATIONS ON H.R. 3474, THE COMMUNITY DEVELOPMENT, CREDIT ENHANCEMENT AND REGULATORY IMPROVEMENT ACT OF 1993.

THE SUBCOMMITTEE MEMBERS ALL HAVE A COPY OF MY STATEMENT. HOPEFULLY IT GIVES YOU SOME USEFUL BACKGROUND INFORMATION ON HFC AND OUR PARENT COMPANY, HOUSEHOLD INTERNATIONAL. IT TRIES TO EXPLAIN TO YOU WHY THIS LEGISLATION IS SO IMPORTANT TO US. HOWEVER, IN THE LIMITED TIME AVAILABLE TO ME THIS MORNING, I WOULD LIKE TO FOCUS MY COMMENTS IN TWO AREAS: (1) OUR SUPPORT FOR THE REVISIONS TO H.R. 3153 WHICH THE CHAIRMAN HAS INDICATED HE WOULD LIKE TO OFFER AS A MANAGER'S AMENDMENT TO THE BILL; AND (2) SHARE WITH YOU OUR COMPANY'S VISION OF WHAT

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PRIVATE SECTOR CONSUMER FINANCE COMPANIES LIKE HFC SEE AS THEIR CONTINUING FUNCTION IN SERVING CUSTOMERS UNDESERVED BY TRADITIONAL DEPOSITORY LENDERS.

THERE IS A RELATIONSHIP BETWEEN THESE TWO POINTS. FOR 116 YEARS, WE HAVE SPECIALIZED IN SERVING CUSTOMERS OF MODEST MEANS. WE ARE STRIVING TO CONTINUE THIS ROLE IN COMMUNITIES ACROSS THIS COUNTRY IN CREATIVE AND INNOVATIVE WAYS THAT I WOULD LIKE TO TELL YOU ABOUT THIS MORNING. THE CRITERIA THAT WE WOULD USE TO JUDGE WHETHER THE REVISED VERSION OF H.R. 3153 IS SUPPORTABLE PUBLIC POLICY IS THIS — HOW IS IT GOING TO BENEFIT OUR TRADITIONAL CUSTOMER BASE AND IS IT GOING TO HAVE A NEGATIVE IMPACT ON OUR ABILITY TO REACH OUT TO NEW CUSTOMERS WHO WISH TO DO BUSINESS WITH HFC?

ON PAGE SIX OF MY STATEMENT, OUR CONCLUSION IS THAT THE REVISED VERSIONS OF H.R. 3153 AND HFC'S OPERATING PHILOSOPHY ARE BOTH PREMISED ON THE BASIS THAT WHAT OUR

CUSTOMER'S NEED AND WANT IS IMPROVED PLAIN LANGUAGE DISCLOSURE. DISCLOSURE LAWS THAT WILL ALLOW THEM TO MAKE AN EDUCATED, INFORMED CREDIT DECISION. ALTHOUGH WE WERE NOT ABLE TO INITIALLY SUPPORT H.R. 3153 AS IT WAS INTRODUCED, WE NOW SUPPORT THE REVISIONS SUGGESTED BY CHAIRMAN KENNEDY IN HIS MARCH 17, 1994 LETTER TO US OUTLINING HIS SUPPORT FOR A MANAGER'S AMENDMENT.

ON PAGES SEVEN THROUGH NINE, YOU WILL FIND A MORE DETAILED EXPLANATION OF THE FIVE MAJOR AREAS THAT OUR COMPANY HAD DIFFICULTY WITH IN THE ORIGINAL TEXT OF H.R. 3153. WE GO ON TO STATE HOW THE REVISIONS SUGGESTED BY THE CHAIRMAN REPRESENT A SATISFACTORY IMPROVEMENT IN THE BILL SO MUCH SO THAT WE ARE NOW WILLING TO SUPPORT THIS BILL SO LONG AS IT REMAINS TIGHTLY FOCUSED AS IN THE "MANAGER'S AMENDMENT" SUGGESTED BY THE CHAIRMAN. WE RECOGNIZE THAT A MANAGER'S AMENDMENT NORMALLY IMPLIES A BI-PARTISAN EFFORT WITH THE MINORITY MEMBERS. SOMETHING WE TRUST CAN BE WORKED OUT. I WOULD WELCOME YOUR QUESTIONS ON THE SUBSTANCE OF THE BILL WHEN YOU QUESTION THE PANEL.

THAT SAID, I WOULD NOW LIKE TO USE THE BALANCE OF MY TIME TO REPORT TO YOU ON WHAT OUR COMPANY IS DOING TODAY IN THE COMMUNITIES OF THE 36 STATES SERVED BY HFC. I BELIEVE IT IS IMPORTANT FOR YOU TO KNOW, THAT DESPITE THE ABUSES DRIVING TODAY'S LEGISLATIVE DISCUSSION, THAT MANY MANY COMPANIES SUCH AS HFC TAKE SERIOUSLY THEIR DUAL RESPONSIBILITIES FOR INTEGRITY IN THEIR CUSTOMER RELATIONSHIPS AND FOR SERVICE TO THE COMMUNITIES WHERE WE DO BUSINESS.

AS I TOLD YOU I HAVE WORKED FOR HOUSEHOLD FOR A VERY LONG TIME. I BEGAN MY CAREER AS A TRAINEE IN A BRANCH OFFICE IN LAKE RONKONKOMA, N.Y. BACK IN 1964.

BACK THEN TO THE BEST OF MY RECOLLECTION, WE HAD 20 BRANCH OFFICES ON LONG ISLAND, 7 SERVICING WEST CHESTER COUNTY AND 55 IN THE FIVE BOROUGHS OF NYC. 82 BRANCHES IN DOWN STATE N.Y.

THESE BRANCHES, SEEMINGLY ON EVERY CITY CORNER, SERVED CUSTOMERS OF MODEST MEANS WHO WERE NOT WELL SERVED BY BANKS. THESE PEOPLE WERE NOT POOR CREDIT RISKS, THEY SIMPLY WERE NOT GREAT CREDIT RISKS AND THEY WERE EXPENSIVE TO SERVE. WE MADE THEM MODEST LOANS, $800 SIGNATURE LOANS WERE THE LARGEST WE MADE IN THOSE DAYS. WE HELPED PEOPLE PAY BILLS, AIDE RELATIVES AND TAKE VACATIONS. WHEN ADVERSITY OCCASIONALLY OVERTOOK THEM, WE WORKED WITH THEM, WE DID NOT CUT THEM OFF FROM CREDIT AND WE WERE STILL THERE ONCE THEY WERE BACK ON THEIR FEET.

MR CHAIRMAN, THINGS HAVE CHANGED A LOT IN 30 YEARS.

TODAY WE HAVE ONLY 12 BRANCHES IN DOWN STATE N.Y. INSTEAD OF 82. WE MAKE VERY FEW SMALL CLOSED END SIGNATURE LOANS. TODAY WE PRIMARILY OFFER REVOLVING LOANS SO THAT BUSY CUSTOMERS ARE NOT REQUIRED TO VISIT OUR BRANCHES TO HAVE THEIR CREDIT NEEDS MET. TODAY SIXTY-FIVE PERCENT OF

6

OUR NEARLY $12 BILLION BUSINESS OF MANAGED RECEIVABLES ARE HOME EQUITY LOANS. THE AVERAGE SIZE OF THESE LOANS IS $35,000.

A LOT INDEED HAS CHANGED. TO MANAGE THE COSTS, WE HAVE BEEN FORCED TO REDUCE OUR BRANCH PRESENCE, CHANGE OUR PRODUCT FOCUS AND INCREASE OUR LOAN SIZE TO MEET CHANGING MARKET CONDITIONS.

WHY DID THIS HAPPEN? WELL . . .

CREDIT CARDS HAPPENED, TWO SPOUSES WORKING HAPPENED, A RISING UNDER CLASS HAPPENED, BANKRUPTCY REFORM HAPPENED. ALL THESE THINGS, SOME GOOD, SOME BAD, SOME JUST THERE. ALL SERVED TO INCREASE OUR COST OF DOING BUSINESS AND CAUSED US TO SEEK TO LOWER OUR COSTS TO REACH AND SERVE OUR CUSTOMERS.

BUT ONE THING HASN'T CHANGED. OUR CUSTOMERS. WE STILL SERVE A CUSTOMER WHO IS NOT WELL SERVED BY OUR COMPETITORS.

IT'S NOT THAT OUR CUSTOMER HAS NO CHOICE. IN MANY REGARDS, OUR CUSTOMER REPRESENTS A DIVERSE CROSS SECTION OF WORKING CLASS AMERICA. HE HAS THE BASIC QUALIFICATIONS TO GO TO OUR COMPETITORS. HE CHOOSES TO COME TO US. HE CHOOSES TO STAY WITH US.

WE HAVE DONE EXTENSIVE RESEARCH TO SEE WHY. HERE IS THE ANSWER. WE TREAT HIM RIGHT. WE COMPLY WITH HIS NEEDS FOR LOW MONTHLY PAYMENTS AND FAIR TREATMENT IN TIME OF TROUBLE. WE TELL HIM THE TRUTH.

AS PROOF OF THIS, I OFFER THE FOLLOWING: WE ARE THE LARGEST PROVIDER OF HOME EQUITY LOANS AMONG CONSUMER FINANCE COMPANIES AND ARGUABLY THE LARGEST AMONG ALL U.S. LENDERS OF ANY KIND.

AND WE ARE INVESTING MASSIVELY IN OUR BUSINESS TO EXPAND OUR REACH. OVER THE LAST 7 YEARS, WE HAVE SPENT OVER $150,000,000 ON SYSTEMS AND FACILITIES WHICH IMPROVE OUR ABILITY TO SERVE OUR CUSTOMERS. THESE SYSTEMS HAVE ALSO ENABLED US TO SIGNIFICANTLY LOWER OUR COSTS OF DOING BUSINESS.

THIS CAPABILITY HAS HELPED US SEEK OUT NEW UNSERVED CREDIT CUSTOMERS. IN 1992 WE BEGAN AN EFFORT TO SPECIFICALLY TARGET THE FIRST AND SECOND GENERATION HISPANIC POPULATION. WE BEGAN THIS EFFORT IN TEXAS AND CALIFORNIA. BECAUSE OF THE SUCCESS OF THIS PROGRAM, WE HAVE EXPANDED OUR PRESENCE IN THOSE STATES AND MOVED INTO ILLINOIS AS WELL. THIS YEAR, WE PLAN TO EXPAND OUR FOCUS TO THE TOP 25 BRANCH OFFICES FOUND WITHIN THE DENSEST CONCENTRATION OF HISPANIC POPULATIONS.

LAST YEAR AS A PART OF A PLANNED RETURN TO THE INNER CITIES, WE OPENED AN OFFICE IN THE RIOT AFFECTED AREA OF LOS ANGELES. WE HAVE BEEN AMAZED AT THE RESPONSE. ON OPENING DAY, PEOPLE CAME INTO OUR NEW OFFICE SINGING OUR OLD JINGLE AND WAVING HFC IDENTIFICATION CARDS THAT WERE DECADES OLD. THIS BRANCH IS GROWING FASTER THAN OUR TYPICAL SUBURBAN UNITS AND THE QUALITY OF OUR CUSTOMERS IS ON A PAR WITH SUBURBAN CREDITS. A SECOND INNER CITY OFFICE WILL OPEN IN SOUTH JAMAICA, N.Y. SOON AND THREE MORE WILL OPEN THIS YEAR.

THE HISPANIC OFFICES AND THE INNER CITY BRANCHES ARE MANAGED, STAFFED, AND SUPPORTED BY HFC PERSONNEL OF ETHNIC AND CULTURAL AFFINITY TO THE PEOPLE THEY SERVE. WE STRONGLY BELIEVE THAT IS THE SECRET OF THEIR SUCCESS.

AND I WANT TO MAKE CLEAR, WE ARE NOT DOING THIS OUT OF ALTRUISM, WE ARE DOING THIS BECAUSE NOW THAT OUR COSTS ARE IN LINE, THERE ARE PROFITS TO BE MADE IN SERVING THESE MARKETS.

OUR EXPERIENCE IN THESE OFFICES -- AND OUR OTHER OFFICES SERVING THE BLUE COLLAR COMMUNITIES OF AMERICA -- IS WHAT BRINGS US HERE TODAY. WE SHARE THE HORROR OF THE COMMITTEE OVER THE ABUSES THAT WERE UNCOVERED IN GEORGIA AND ELSEWHERE.

WE, OF COURSE, WOULD HAVE HOPED THAT MARKET FORCES WOULD HAVE PREVAILED TO PROTECT THE VULNERABLE INDIVIDUALS CITED THROUGHOUT THESE AND YOUR EARLIER HEARINGS. BUT THEY DID NOT AND WE RECOGNIZE THAT CONGRESS -- AND THIS SUBCOMMITTEE SPECIFICALLY -- WAS FORCED TO ACT. WE ARE SATISFIED THAT YOU PROPOSE TO ACT TEMPERATELY AND IN A FASHION WHICH WILL NOT HAVE THE EFFECT OF REDUCING ACCESS TO CREDIT FOR THOSE YOU WISH TO PROTECT.

YOU HAVE TARGETED THE AREAS OF ABUSE AND THAT IS WISE. YOU HAVE DECIDED TO FOCUS UPON DISCLOSURE RATHER THAN RESTRICTION OR PRESCRIPTION AND THAT IS PRUDENT. YOU HAVE HELD THE END LENDER ACCOUNTABLE, SO LONG AS HE IS NOT HIMSELF DEFRAUDED, FOR DUE DILIGENCE IN WHAT HE BUYS AND THAT IS NOT UNREASONABLE.

MR. CHAIRMAN, BY THESE ACTIONS YOU HAVE DEMONSTRATED THAT YOU WISH NOT ONLY TO ELIMINATE ABUSE, BUT ALSO TO ALLOW AND ENCOURAGE THE MARKET TO PROVIDE CREDIT ACCESS TO THOSE WHO MADE IT. IN THAT VEIN AND WITHIN THAT TIGHT FRAMEWORK, WE SUPPORT YOUR EFFORT.

TESTIMONY OF HARRY H. KUTNER, JR.

I. BACKGROUND.

Mr. Kutner is a trial attorney with extensive experience whose office is in Mineola, Long Island, New York. He will detail the actual consumer fraud *from both sides*. At one time, he defended a home improvement contractor who later was blamed for having concocted this consumer fraud. When Mr. Kutner became aware that the allegations against his client appeared credible, he withdrew from further representation of that client. He now represents hundreds of homeowners who have been victimized by a new more refined version of his client's original fraud.

From the unscrupulous home improvement contractor's perspective, there is no exaggeration or lie too great to be told to the homeowner as long as the homeowner's signature is obtained on the papers. Frequently, all of the required bank papers are executed in blank, contract prices if not initially exorbitant are sometimes later changed by adding digits, the papers are backdated, the consumers are never told about the actual finance charges nor that there are mortgages hidden within the papers, nor that they are jeopardizing their homes, etc., etc.

One of the pet sales pitches used by the unscrupulous tin man was that the homeowners were eligible for "The Federal Program", non-existent and an outright lie used to convince the minority homeowner that some federal money is available which makes the loan affordable. Mr. Kutner will furnish further details as to how the home improvement scam is put forth.

After being introduced to CAROLINE BERGER by Catholic Charities on Long Island, Mr. Kutner was able to predict nearly every con used by the contractor, and even some shenanigans not theretofore realized by her, Catholic Charities and her first attorney who was unfamiliar with the type of scam. Mrs. BERGER was a blind, 66-year old black lady who resided in Roosevelt, Nassau County, New York, in a tiny Cape Cod - style home with her retarded granddaughter and brain-damaged great-granddaughter. On an income of approximately $1,800.00 per month, her six (6) mortgages exceeded $1,400.00 per month. The net income left had to cover food, utilities, medicines, clothing, etc. Somehow, some way, when Mr. Kutner met Mrs. BERGER, she was almost current with all six (6) mortgages accomplishing it by nearly starving. Mr. Kutner will relate the details of each of the four (4) contracts which Mrs. BERGER unwittingly signed, at unconscionably-high prices for the work involved, for shoddy and incomplete work, and even to the extent that the fourth (4th) contract called for the replacement of work done only thirteen (13) months earlier under the first contract !

Mr. Kutner will also relate how he quickly suspected the same scheme as being involved in the case which he previously defended, and therefore realized it was not isolated to Mrs. BERGER but was widespread and likely involved dozens if not hundreds of other homeowners. Through his efforts, Catholic Charities jointly with the NAACP spread newsletters throughout predominantly black communities seeking other victims of the fraud as well as warning persons not to get involved with the contractor or the finance company. Characteristically, Mr. KUTNER will relate that the homeowners are often embarrassed and do not come forward, also possibly attributed to their fear that they are going to victimized once again by the "system". Instead, Mr. Kutner researched County Clerk records and uncovered numerous other homeowners whose home improvements had been sold by the same unscrupulous contractor, financed by the some unscrupulous finance company, and later sold to banks.

The banks themselves, according to Mr. Kutner, seem to fall into two (2) main groups: 1) those who might also be victims of the fraud in that they unwittingly purchased the mortgages because the paperwork seems to be in order; and 2) banks whose loan officers have been compromised by the unscrupulous finance company.

Although some banks have protested their complete innocence of the scheme, Mr. Kutner believes they are not blameless in refusing to see the obvious. Also, he will relate how the practice victimizes the minority homeowner since the interest rate

is very much higher than the prevailing rate for secondary financing, for homeowners who have absolutely no credit. Simple verification of each homeowner's credit in most instances would have revealed to the banks who claimed to also be victims, that these persons were un-creditworthy. Similarly, even the most cursory investigation, even to the extent of periodic spot checking of every fifth, tenth, or some other arbitrarily-numbered mortgage, would have quickly revealed the scheme. The above-market, exorbitant interest rates themselves should at least have alerted the so-called victimized banks to do some spot-checking to determine whether the security was credible.

It is Mr. Kutner's experience that most often the banks are co-conspirators with the unscrupulous tin men and financiers in that their own employees are compromised through commercial bribery of one form or another to purchase the loans.

The original scheme contributed to the collapse of Flushing Federal Savings & Loan in Queens, New York in the early 80's and the 1991 federal conviction of its president of forty-four (44) or forty-eight (48) counts. As an example, in that case it was alleged that the bank president was accepting various gratuities in order to buy the loan. In the current litigation being prosecuted by Mr. Kutner on behalf of the minority homeowners, he has been informed by the Secret Service that a loan officer of one particular bank was bribed in a similar fashion in order to purchase the loans.

II. PROPOSED REMEDIAL MEASURES.

Mr. Kutner will urge the house to pass HR # 3153 as proposed as a means of giving banks an incentive to be more circumspect and responsible in purchasing loans. It will not hamper lending since loans made to un-creditworthy persons are financially self-defeating in any event, costing the banks' investors or the taxpayers millions of dollars in losses.

Mr. Kutner will also urge further remedial legislation directed at the inception of the scheme, namely the unscrupulous home improvement contractors and the middle-man finance company who acts as the conduit between the contractors and the banks. He will urge a series of provisions which will make it easier not only for the homeowners, but also for the victimized banks to recover any losses suffered:

a. treble damages;

b. asset forfeiture provisions similar to other federal statutes to be applied to the perpetrators of the fraud including tracing of assets, etc.;

c. piercing of the corporate veil of the contractors and finance companies to render liable the largest equity shareholders, officers and directors;

d. the absolute prohibition of any loans greater than an established interest rate ceiling.

The reason Mr. Kutner will urge the final provision is that homeowners who are un-creditworthy or who have difficulty obtaining

financing at the market rates, will obviously not be able to pay the exorbitant interest rate. Therefore, the loan itself should not be made. While not presuming to be a banker, Mr. Kutner, as a businessman and representing businessmen, realizes that it does not the suit banks' financial goals to make loans wily-nily to anyone just for the sake of making loans, especially if they are to un-creditworthy people who are likely to default. In many of these cases, the real estate has already been 100% mortgaged and the additional loans end up being un-secured. Or, in a declining real estate market, the equity disappears thereby leaving the bank with no security.

NAMB

National Association Of Mortgage Brokers

Written Statement of the

NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Before the

CONSUMER CREDIT AND INSURANCE SUBCOMMITTEE

of the

HOUSE BANKING, FINANCE AND

URBAN AFFAIRS COMMITTEE

on

H.R. 3153

MARCH 22, 1994

10:30 A.M.

NAMB HEADQUARTERS
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Table of Contents

Written Statement of the

NATIONAL ASSOCIATION OF MORTGAGE BROKERS

Before the

CONSUMER CREDIT AND INSURANCE SUBCOMMITTEE

of the

HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

of the

UNITED STATES HOUSE OF REPRESENTATIVES

on

H.R. 3153

MARCH 22, 1994

10:00 A.M.

INTRODUCTION

Mr. Chairman and members of the Subcommittee. My name is Joseph Falk, and I am testifying on behalf of the four thousand plus members of the National Association of Mortgage Brokers (NAMB). NAMB is a national society of professional mortgage brokers and affiliated state organizations. Mortgage brokers are estimated to originate almost one-half of all residential mortgages in the nation. We are a growing, dynamic, and energetic group of civic-minded mortgage industry professionals.

Mortgage brokers match potential borrowers to a wide variety of prospective lenders. H.R. 3153 will affect a certain segment of our loan originations.

I also serve as president-elect of the Florida Association of Mortgage Brokers (FAMB), founded in 1959.

NAMB is pleased to have the opportunity to offer a mortgage broker's perspective to the issues raised by H.R. 3153, the purpose of which is "to protect home ownership and equity through enhanced disclosure of the risks associated with certain mortgages, and for other purposes." NAMB is committed to the highest level of professional standards, full disclosure, and consumer protections. We believe that predatory lending should be eliminated. We believe in making home ownership and equity loans available to all segments of society.

NAMB respects the Committee's desire to protect consumers from unscrupulous and predatory lending practices which prey on the defenseless and rob the poor. The prevention of the many atrocities revealed in prior hearings is a noble and worthy cause, and NAMB wholeheartedly supports the goal.

Testimony given at previous Congressional hearings on the issue indicates many of the predatory lending practices stem from door-to-door sales of home improvement services and materials. The solution provided in H.R. 3153 goes beyond addressing predatory practices and creates new, unintended consequences. Transactions entered into voluntarily by consumers, with full knowledge and disclosure, would be prohibitad. This legislation, if enacted as drafted, will severely limit access to credit, especially to borrowers with poor credit histories.

We have been informed that some of our concerns may be addressed in amendments

to the bill. We thank the Subcommittee for addressing some of our concerns, but urge you to consider others which we will highlight in this statement.

H.R. 3153 would amend the Truth in Lending Act (TILA). Its stated purpose is to "promote the informed use of consumer credit by requiring disclosures about its terms and cost."[1] (Emphasis added.) However, H.R. 3153, unless it is dramatically amended, will place prohibitions on the terms of available credit and impose unrealistic requirements on a creditor's judgment of an applicant's capacity. Furthermore, it creates a fiduciary duty by the lender to the borrower by requiring the lender to represent to the borrower the borrower's own income.

Some might argue that consumers would be better off if high risk loans were prohibited, but prohibiting certain types of loans is not the objective of TILA. NAMB suggests that a different prohibition would address the problem. We believe that individuals and firms who arrange non-conforming mortgage financing should be prohibited from collecting a fee if the individual or firm is otherwise involved with the consumer in providing home improvement services. Section 129 (a)(1) of H.R. 3153 requires the lender to disclose that the borrower's home is collateral for the loan, and section 129(b) provides for a three-day waiting period prior to consummation of the transaction. These provisions should be sufficient to inform borrowers that the transaction is more than a simple contract and could result in foreclosure and loss of the home.

In 1934 the National Housing Act created the Federal Housing Administration (FHA)

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[1] Regulation Z - Truth in Lending, 12 CFR 226.1(b).

which is credited with initiating and popularizing many innovations in mortgage lending. Among them are mortgage insurance and the amortized mortgage. Before that time, virtually all mortgages were from 3 to 5 years in duration and had loan-to-value ratios of 50% or less. The federal government thus created a long-term mortgage market. FHA and its cousins Fannie Mae and Freddie Mac have been tremendously successful in creating capital markets for conforming loans, primarily because of their direct or implicit government backing.

No such market exists in high risk residential mortgage lending, where there is no government backing and where short-term money prevails. Conventional markets where no implicit government backing exists operate similarly to our non-conforming markets. Short-term mortgage markets are common throughout the world. "The average composition of the mortgage portfolios of most Canadian financial institutions today includes an average term to maturity of two to three years."[2]

H.R. 3153 would require non-conforming lenders and borrowers to play by the same rules as conforming lenders and borrowers; yet it does not provide even implicit government backing. To the contrary, borrowers are told they are being charged excessive fees at above-market rates, even though the government-backed markets are inaccessible.

Most borrowers of non-conforming mortgages have already been turned down by the government-sponsored programs which support fully amortized loans. The banks and savings and loans would be subject to severe criticism from regulators for holding

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[2]Wahl, *A Canadian Perspective*, Mortgage Banking, Sept. 1993 at 78.

assets of this nature in their portfolios. These borrowers do not meet Fannie Mae, Freddie Mac, FHA, or VA underwriting guidelines. The result of forced long-term exposure to these risks will be much higher costs. Higher interest rates require higher payments, leaving less residual income which in turn increases risk and leaves fewer qualifying borrowers.

WHO ARE THE BORROWERS THAT WOULD BE AFFECTED BY H.R. 3153?

Borrowers from every segment of the socio-economic spectrum will be affected by the legislation. While some are low-income borrowers, many are middle- and upper-income borrowers who are in transition because of job changes, divorce, medical costs, or who are trying to raise venture capital to start their own businesses. These borrowers may have been turned down by banks, savings and loans, credit unions, and conforming mortgage bankers, but they still need the money, and they expect to pay it back. They are no less responsible, no less honest or well-meaning; yet, in most cases, they have less control over their immediate capacity to repay than borrowers who qualify for conforming loans.

One such case is that of Denise Mitchell of Sanford, Florida, a town of 25,000 people. Denise and her husband owned their home free and clear, and dreamed of owning their own business. They shopped at various banks and other institutions, but their loan application was rejected. Their credit was bad because each had previously been divorced, and no one would approve a business loan. Fortunately, they were able to find a non-conforming lender who approved their loan. They started a

business and eventually employed 50 people. H.R. 3153 would prohibit this proper extension of credit.

When borrowers reach the non-conforming lenders' doors, they have no other source of financing. Occasionally, the loans are made with only days remaining before a foreclosure sale. "High cost mortgages" allow borrowers to bring their mortgage current and give them time to sell their homes on the open market. In this way they salvage their equities and do not lose their homes through a foreclosure auction.

Borrowers who have lost their jobs - timber workers in the Northwest, civilians affected by defense base closures, or middle management and labor layoffs through corporate downsizing and automation - need to buy time. With time they can reestablish a stable income or a consistent pattern of repayment without delinquency.

The Clinton Administration, Congress, and HUD have made it clear that lenders must examine their practices and take every opportunity to get low- and moderate-income and minority borrowers into conforming loan programs. Applicants that do not qualify under conforming guidelines must turn to non-conforming lenders for necessary loan funds. These applicants must not lose that alternative.

WHO ARE THE LENDERS THAT MAKE THESE LOANS?

Lenders who are unable to utilize the uniform underwriting guidelines of Fannie Mae, Freddie Mac, or FHA, are vastly different from conforming mortgage lenders. In the

high-risk market, each borrower's circumstance is unique, requiring highly customized evaluation. All underwriters look at the borrowers' character, capacity, and collateral - the "three Cs" of underwriting. Character indicates a willingness to pay as demonstrated by credit history. Capacity reflects the borrower's actual income and the stability of the income. The collateral is the real property used to secure repayment of the loan. Lenders who make the loans that would be subject to H.R. 3153 generally do not give these characteristics the same weight as a conforming lender. The non-conforming lenders' underwriting flexibility allows them to emphasize one characteristic over another. Compensating factors are common in the conforming market, but they are taken to a greater extreme in the non-conforming market.

With such variances in underwriting guidelines, it is difficult to establish a capital market. No mortgage company or bank can continue to loan money without an external source of capital. Both the customized underwriting and special borrower circumstances make capital markets more wary of riskier non-conforming loans. Of course, there is a cost associated with that risk. Interest rate is a major factor in risk evaluation. Most non-conforming mortgage lenders have a scale of risk and corresponding interest rates denominated as "B", "C", and "D" credit.

It is not only large corporations that make non-conforming mortgage loans. Individuals, many of whom are retired, invest directly in mortgages. Small mortgage brokers, with their unique and customized services, facilitate the joining of non-conforming borrowers with capital markets. Secured loans, both conforming and non-conforming, are generally safer and provide a less volatile return than the stock market. Mortgage brokers verify the borrowers' documentation and provide a

complete package for the investor to evaluate. If the package is acceptable, the investor funds the loan. A more sophisticated mortgage brokerage firm may service the loan for the investor.

WHY THE ABUSE?

Last year's Senate and House Banking Committee hearings indicated that "reverse redlining" was a significant factor in the abuses that took place. Redlining is the practice of isolating a particular geographic area and refusing to make loans in that area. Redlining in and of itself is not illegal. For example, legitimate redlining may result when a lender elects not to make loans on properties located within a flood plain. In practice, however, redlining generally refers to discrimination based on a protected category of borrower. The Equal Credit Opportunity Act and the Fair Housing Act protect certain categories of borrowers and prohibit discrimination on the basis of race, color, religion, national origin, age, sex, marital status, handicap, public assistance income, and others.

The practice of "reverse redlining," then, is the practice of targeting certain geographic areas for mortgages. In a declining neighborhood where conforming creditors tend not to do business, the supply of money is low and demand for loans is great. With increased demand comes higher prices. The single most important way to relieve this phenomenon is to stabilize supply.

Unfortunately, H.R. 3153 does not solve the inequities of capital availability. In fact, if

passed, the bill will drastically reduce supply in this already capital-depleted market.

The community development bank proposals which are moving through the House and Senate will help revitalize the flow of capital into the communities affected by reverse redlining. NAMB fully supports this proactive approach to solving the problems at hand and cannot support efforts that will result in restricted access to credit before these initiatives have been implemented.

A SPECIFIC EXAMINATION OF H.R. 3153

Definitions

Section 2 (a) - High Cost Mortgage

A "high cost mortgage" is one in which the annual percentage rate (APR) of the loan exceeds by more than 10 percentage points the rate of interest on U.S. Treasury Bills of one year. We understand the Subcommittee proposes to change this to an index based on "treasury securities of comparable maturity." **NAMB supports comparable maturity indexing.**

A mortgage would also be deemed to be "high cost" where the total points and fees exceeds the greater of 8 percent of the amount financed or $400.

TILA requires the disclosure of Annual Percentage Rate (APR). APR is calculated by

subtracting the prepaid finance charges from the gross loan amount and recalculating the yield/cost based upon the repayment requirements. To be consistent, fees included in the 8 percent of points and fees of a high cost mortgage should parallel items used to calculate APR on a mortgage not deemed "high cost." This type of mortgage could have similar title insurance, appraisal, and other third-party provider costs that are not used to calculate the APR. If all items paid by the applicant are counted toward the 8 points, as H.R. 3153 requires, the amount would include the costs of hazard insurance, real property taxes, and debts being paid off at the closing of the loan. **NAMB strongly urges the inclusion of only those costs in the 8-point determination factor for high cost mortgages that are fees used to calculate the APR for a non-high cost mortgage.**

SECTION 2(c) - Creditor

TILA's current definition of creditor is one who "regularly extends" consumer credit. H.R. 3153 proposes to modify this definition to apply to anyone who makes two or more high cost mortgages within a twelve-month period of time, or one who makes only one high cost mortgage through a loan broker in his or her entire lifetime. There is no twelve-month limitation on brokered loans.

The dual definition of creditor seems to abandon the test of "regular activity" in the field. The non-conforming mortgage market has a large number of private investors, meny of whom are retired people seeking to better their incomes with secured investment opportunities. This bill would require small private investors to understand

TILA as well as sophisticated large lenders.

We understand the actions that led to this bill involved large scale lenders, not private parties using a mortgage broker to make one loan in their lifetime. If a person does not "regularly extend" credit, the potential for damage to the consumer is negligible. On the other hand, the large corporations will not escape the existing definition of lender within TILA. **NAMB believes the objectives of Congress can be met by applying the same test of regular extension of credit to non-conforming mortgage creditors as to any other creditor for purposes of TILA.**

Required disclosures

H.R. 3153 would require seven additional disclosures. Three of them - items 2, 4 and 5 - are already required by TILA to be shown in the Federal Box Form for APR disclosures.

Items 1,6, and 7 are acceptable disclosures. Each is a simple statement. All three could easily be added to the existing Federal Box Form when appropriate. This is preferable to creating additional documentation.

Item 3 requires the lender to represent to the borrower the borrower's own income. This places a fiduciary duty upon the lender.

Mortgage underwriters use many different methods to verify income. Each of these

methods could now be subject to regulatory or court determination of their adequacy. These four simple lines in the statute may require volumes of rules to assist the jury in determining whether the borrower should have been able to repay the loan. When not passing judgment upon the borrower, the courts will be busy performing quality control evaluations by determining whether a lender diligently verified the applicant's income. A legitimate creditor should not be subject to violation of this act as the result of borrower misrepresentation. **NAMB believes item (3) page 4, lines 4-7, should be stricken. Additionally, NAMB suggests the following disclosure be added: "The borrower is responsible for his or her own actions. The lender is not the agent, counselor, or representative of the borrower. The borrower is advised to seek legal counsel."**

Prohibited acts

The bill currently prohibits ten distinct loan terms or activities. At least two of these, we have recently learned, may be amended, action we will support. The prohibitions apply to: modification of terms after disclosure is provided; prepayment penalties; increased note rates on default; refinancing by the same lender or an affiliate (the proposed change would add language that permits refinancing if the APR is lowered); balloon payment mortgages (with a six-year minimum term acceptable under the proposed change); negative amortization; prepaid payments; refinancing of lower rate mortgages; financing a mortgage broker's commission; and disbursing loan proceeds to home improvement contractors.

We do not believe the above practices and terms, in and of themselves, are abusive. Please consider the following:

Section 129(b) - Modification of terms after disclosure

This section prohibits the modification of any terms after the delivery of the disclosures made at least three days before closing. This would prohibit lowering costs as well as raising them. Additionally, it is not uncommon to prepare for a closing while waiting for final documentation in support of the borrower's loan application, such as tax returns, verification of deposit, verification of employment, and title insurance reports, to arrive. Under the terms of this bill, the closing would be further delayed if documentation verifies an amount that varies from the one expected. **NAMB recommends deleting this provision.**

Section 129(c)(1) - Prepayment penalties

Prepayment penalties are tools that reduce upfront costs to the borrowers. A lender requires certain returns to break even. The reduction of upfront fees is offset by assurances of the longevity of the loan. If the borrower does not meet the anticipated returns, the lender is compensated. Alternatively, the lender can charge more at the time of origination to protect from the unknown exposure of servicing portfolio runoff. The only borrowers adversely affected are those that actually pay off early. In H.R. 3153, all consumers would pay higher upfront costs.

Most mortgage lenders are not portfolio lenders, that is, they do not have money to lend. Instead, they borrow it or sell the loans and retain the servicing rights for a small interest rate spread. In a loan of short duration, the return on servicing alone is not great enough to offset the risk.

It is a common practice in the industry to allow prapayment penalties to be "bought out." This is typically accomplished by paying an extra point or two at origination. These extra fees remove the risk of portfolio runoff, and would be charged if penalties are prohibited. An appropriate alternative would be to allow the borrowers to decide what is best for their situation. This could be done by requiring alternative pricing that would reduce or eliminate the prepayment penalty. The borrowers are best able to judge their individual needs. **NAMB recommends allowing the borrower to alter the rate, fees, or both to reduce or remove the prepeyment penalties. Alternatively, H.R. 3153 could allow prepayment penalties to be charged if the loan is paid off during the first two years of the loan.**

Section 129(c)(1) - Increased interest rates on default

Non-conforming mortgages have a greater potential for default. Lenders can lower the initial interest rate on these mortgages by increasing the interest rate on defaulted loans. Servicing a loan portfolio that contains defaulted mortgages is much more costly than servicing a performing portfolio. If the user-assessment method of charging increased rates to those in default is prohibited, the overall rates to all borrowers will undoubtedly increase. **NAMB recommends deleting this subsection.**

77-605 - 95 - 5

Section 129 (c)(3) - Refinancing by the same lender or an affiliate

This prohibition would prevent lenders from further meeting their clients' needs unless the service is performed at a loss. A change is being contemplated that would permit refinancing if the APR on the new loan is lower than that on the loan being refinanced. **NAMB supports the deletion of this provision in its entirety. The proposed change is a step in the right direction, but does not go far enough.**

Section 129(d) - Balloon payment mortgages

The problem being addressed results largely from one-year mortgages along with the charging of fees for refinancing. A three-year balloon would eliminate these abuses. Furthermore, balloon notes are less costly than longer-term notes. In most cases, the shorter the term, the lower the interest rate. If the borrowers plan to move in two years, we believe they should have the option of making lower payments for the two years. **NAMB supports a three-year balloon. NAMB is pleased the Subcommittee has recognized the viability of balloon mortgages, but believes three-year balloon mortgages provide adequate protection to borrowers.**

Section 129(e) - Negative amortization

Negative amortization is a method of repayment in which the regular payment is less than what is called for by the amortization schedule. The payment amounts are less

than the interest that is due. The unpaid interest is added back to the balance of the loan as additional borrowed funds. The borrower is borrowing part of the payment each month. Negatively amortized loans are uncommon among high risk mortgage lenders. However, the verbiage of H.R. 3153 would prohibit the inclusion of "terms under which the outstanding principal balance will increase over the course of the loan."

In any standard loan there are numerous terms which provide for an increase in the outstanding principal balance. Many of the terms have nothing at all to do with "negative amortization." The provisions include giving the creditor the ability to protect its collateral by advancing junior lien arrearages, paying real property taxes, advancing hazard insurance premiums, and recovering costs incurred in pursuing foreclosure or other remedies provided by law. **NAMB believes lenders need to be able to advanca moneys to protect their interests, and urges the clarification of this subsection.**

Section 129(f) - Prepaid payments

The scope of this provision may exceed its intent. Many loan programs allow the borrower to "buy down" the initial interest rate so the borrower can qualify for the loan's lower monthly payments. The buydown is either a financed or deposited sum which offsets a portion of the borrower's interest for the first one to three years of the loan. The monthly payments are gradually increased over the buydown period. Programs such as this help borrowers who expect an increase in income over the next

few years but who wish to benefit from the low initial payments.

NAMB acknowledges that not every loan program is appropriate for every borrower. However, prohibiting loans with buydown features will restrict the availability of a valuable tool which has helped many consumers meet their immediate financial objectives. **NAMB recommends allowing loans with buydown features.**

Section 129(g)(1) - Reasonable probability of ability to make payments

Lenders would be obligated to make a fiduciary decision without the accompanying fiduciary control in determining whether borrowers are capable of managing their financial affairs. This provision would involve regulators and courts in after-the-fact underwriting decisions.

Legitimate creditors do not make loans they believe will be unpaid. This provision puts the creditor in the position of turning down more loans because they will not be able to assume the borrower will repay the loan. If a regulator has the power to decide the borrower could not have been expected to pay, the regulator has become the underwriter. Implementing this provision would require the Federal Reserve Board to draft underwriting guidelines for high-risk mortgage lending.

Furthermore, borrowers who are delinquent will have no motivation to continue to pay. In fact, if they quit their jobs or squander their income, they may have a chance of getting the debt forgiven. Why? Because under H.R. 3153, the creditor should have

known that the borrower was not capable of repayment. **NAMB recommends deletion of this subsection.**

Section 129(g)(2) - Taking advantage of the borrower

A borrower's lack of education or sophistication about obtaining a mortgage loan is understandable. The level of sophistication necessary to comprehend the Federal Box Form - APR disclosure is extremely high. Most borrowers, including highly educated people such as doctors, lawyers and professors, do not "understand fully" the APR. The most important concern for borrowers is the required repayment schedule, and the consequences of failure to meet their obligations. It would be impossible for a creditor to prove in court that a borrower fully understood anything. **NAMB believes this provision should be deleted.**

Section 129(g)(3) - Refinancing of lower rate mortgages

NAMB does not believe that preventing a borrower from making an informed decision is an appropriate role for a "disclosure" act. This provision prevents a borrower from paying off what may be an insignificant debt with one that may be significant. Under the current bill, borrowers with an existing $5,000 first mortgage at 7% interest would be prohibited from refinancing and getting $75,000 cash from the equity in their home. Instead of an $80,000 first mortgage loan at 13.5% they might end up with a $75,000 second mortgage loan at 16%. The net result is a loss in the approximate amount of

$1,550 the first year. **NAMB believes that providing adequate disclosure to inform borrowers of the terms of a loan is more appropriate than making the borrowers' decisions for them.**

Section 129(g)(4) - Financing a mortgage broker's commission

This section says that financing a mortgage broker's commission is an unfair or deceptive act _if_ the commission was not disclosed prior to the loan application. A good faith estimate of mortgage broker fees, together with all other costs charged to the borrower, must now be provided to subordinate lien borrowers within three days of loan application. This requirement results from a new rule published by HUD in the Federal Register on February 10, 1994. The rule amends Regulation X of the Real Estate Settlement Procedures Act (RESPA), which was amended by the Community Development Act of 1992 to include coverage of junior lien mortgages. However, under H.R. 3153, the costs would have to be disclosed prior to taking an application. If the mortgage broker does not know what the borrower wants, how can she or he tell the borrower what it will cost? **NAMB believes the disclosure of mortgage broker fees charged to borrowers on the Good Faith Estimate required by RESPA is adequate disclosure to the borrower that a mortgage broker is receiving a fee in the transaction.**

Section 129(g)(5) - Violation of other consumer protection laws constitutes a violation of TILA

This provision implies that a consumer's recourse under other federal and state consumer protection laws is not adequate. **NAMB recommends the deletion of this subsection.**

Section 129(g)(7) - Disbursing loan proceeds to home improvement contractors

In some states, construction and materialman liens take precedence over mortgage liens. Lenders insist the terms of their loans provide for a creditor's ability to satisfy any liens which become senior to the creditor's obligations, thus protecting the creditor's collateral position. Since a contractor has the right to a lien if payment is not made, and the lien if filed will be senior to the mortgage, creditors must maintain the right to satisfy the contractor in full. **NAMB believes this area of the law should be left to the states.**

Section 129(g)(8)(A) - Creating confusion and misunderstanding

Borrowers have varying perceptions, especially when faced with the opportunity to recover all or some costs together with an offset of the remaining indebtedness. The temptation to pursue prosecution based on this claim given the damages that are provided to the borrower under the act may prove too great to resist. This paragraph leaves the creditor with little or no defense. See also Section 129 (g)(2) above. **NAMB recommends that the Federal Reserve Board be given the authority to determine what are unfair, dsceptive, and unconscionable practices.**

Section 129(h) - Right of rescission

This provision does not eliminate the prohibited terms of the contract; rather, it makes a contract unenforceable if the lender includes in it a prohibited term. Standard form notes and trust deeds carry severability clauses that nullify any section which is prohibited without impacting the remaining terms of the loan. **NAMB believes the nullification of prohibited terms is adequete protection to the consumer.**

Section 4(c) - Assignee liability

The assignee is an investor who is a holder in due course. An assignee is not the original lender, and may not have set the terms for the original loan. Passing on all liability to the holder in due course is an excessive burden. Many of these loans are made by private investors, who would be exposed to total loss. Section 4 (d)(1) states that the liabilities of the assignee are in addition to any other liabilities under this title. Is this an addition to the originating lender's finance charges and fees liability? The assignee must "offset all remaining indebtedness; and the total amount paid by the consumer in connection with the transaction."

An assignee may acquire interest in the transaction at some future time, or simultaneously with the closing of the loan. A loan may also be assigned multiple times throughout the course of its life. Are all assignees equally liable? How many times can the borrower collect the same fees and costs? **NAMB urges the deletion**

of this subsection, as the increased liability to the assignee is excessive and unnecessary, and the damages established by section 130 of TILA are sufficient.

CONCLUSION

It is ironic that, in an attempt to protect consumers, H.R. 3153 will inflict great damage upon them. Private money mortgage brokers are small businesses that work with both borrowers and investors, each with their life savings on the line. The implementation of this bill will force a shortage in the high-risk credit market. This would increase interest rates, making it harder for borrowers to obtain any kind of loan. The demand caused by the void of legitimate lenders would undoubtedly be exploited by unscrupulous drifters. To compound the problem, a lack of institutional markets for their paper would only cause these illegitimate operators to attract unwary private investors who are blinded by rate. Those that would engage in such activity will not be concerned about the presence of this law. If this bill could stop illegitimate operators, NAMB would be happy to support it. Unfortunately, we believe the bill will only lead to the reduction of legitimate avenues for the non-conforming borrower to pursue.

MORTGAGE BACKED SECURITIES

A CANADIAN PERSPECTIVE

The Canadian mortgage market is unique in many respects. The basic mortgage instrument and the handful of lenders holding large market share set the market apart. But like the American market, it appears ripe for major growth in its MBS market.

BY IVAN S. WAHL

The mortgage-backed security market in Canada has been in a dramatic growth phase since its introduction in 1985. Though Canada was much later in joining the international trend toward mortgage securitization than the United States, the growth in Canada's MBS market thus far has demonstrated that a significant market segment is showing rapid signs of development.

This article views the MBS market in Canada from the perspective of a Canadian issuer. Further developments in other international markets will be interesting to watch as the beginnings of a truly global MBS market are starting to take shape.

The growth of mortgage securitization outside the United States has developed slowly and certainly not to the same extent as in the United States. The Canadian situation will be dealt with in further detail later on; however, a quick review of developments in other parts of the world is in order.

The second most successful foray into the mortgage securitization market has occurred in the United Kingdom. There, however, broad-based government support and stabilization have been absent, and none of the mortgage-backed security instruments that have developed there have enjoyed the full faith and credit of the British government. Such backing would provide the stability sought by prudent investors.

Something worth noting in the development of the mortgage security market in the United Kingdom has been the fact that the traditional mortgage lenders in that country—the building societies—have not embraced the MBS methodology at all. The net result has been that "new lenders" have been developed, some of which have American sponsorship, such as The Mortgage Corporation Inc., which was sponsored and started by Salomon Brothers. This new breed of lenders captured significant market share in their first few years of operation, and their more-competitive rates and aggressive marketing style fueled the supply of mortgages for the mortgage securitization process in the United Kingdom early on. (More recently these nontraditional lenders have hit on more difficult times, which has affected volume.) However, in recent months, the building societies have become more aggressive in terms of interest rates, and in some cases, they have decided to securitize on their own without the government's involvement.

However, private enterprise has developed some innovative and profitable techniques for mortgage securities, and thus far about £8 billion of mortgage securities have been brought to the public capital markets. This represents only about 3 percent or 4 percent of the national market for mortgages in the United Kingdom.

Australia has had a similarly slow start. There is no single source of published figures, but certainly less than 1 percent of that mortgage market has been securitized at this point.

Recent efforts at growing MBS markets have begun in some European countries, such as France, Sweden, Denmark and Spain.

PHOTOGRAPH BY PPG

TORONTO, CANADA

Canada's home mortgage market

The residential mortgage market in Canada has grown rapidly over the past 20 years and now approximates $285 billion in outstanding residential mortgages. It is, however, dominated by 12 major financial institutions, which control approximately 84 percent of the market. The largest of these players is the Royal Bank of Canada, which has approximately 11 percent of the Canadian market.

This situation, in which similarly structured financial institutions have gained an oligopoly, has led to a somewhat non-competitive situation from the borrowers' point of view. Similar offerings by lenders in terms of interest rates, prepayment privileges and underwriting techniques have left the Canadian homeowner very little choice as to where to apply and the prospects for ultimate funding. As a result, interest rates on mortgages have exceeded 200 basis points over the similar-term Canadian government bond during the past five years.

The development of the Canadian residential mortgage market has taken some significant turns in the past 30 years. Before 1967, the major banks were not a significant factor in the mortgage marketplace because of a restriction on holding mortgages on bank balance sheets, as well as the inability to charge higher than 6 percent on any bank loans.

However, changes contained in the Bank Act of 1967 dramatically turned around the market-share positioning of the various players. The major banks now make up more than 50 percent of the overall market, primarily at the expense of trust companies and, notably, life insurance companies.

In the Canadian mortgage market, the other interesting departure from the U.S. formula has been the elimination of long-term, fixed-rate mortgages. In the early 1960s, Canadian financial institutions— such as trust companies, and later in

the decade, banks—started funding mortgages primarily with similarly termed guaranteed investment certificates (GICs). Because they were unable to issue investment certificates to the public on their deposits for more than five years that would, in turn, be guaranteed by the government of Canada through the Canada Deposit Insurance Corporation (CDIC), these financial institutions found it convenient and prudent to provide mortgages that were no more than five years in length.

This process, in hindsight, appears to have been one of the smarter moves in the world of financial institution regulation and response. The U.S. savings and loan debacle very clearly pointed out the folly of the continued practice of funding long-term mortgages with short-term deposits. As a result, through most of the 1960s and 1970s, the bulk of the Canadian mortgages issued were five years in term; however, the mortgages themselves would be paid off over 25 years.

The limited term (five years) technically required a balloon payment at maturity. In practice, as long as a borrower made reasonably regular payments, most financial institutions used the opportunity at the end of the maturity term to renew the mortgage at a current market interest rate. No further documentation was required, and in many cases, the financial institutions involved did not even register an amending agreement showing the change of interest rate on the mortgage itself. This became an easy way to handle the individual mortgage.

In Canada, again in a departure from U.S. practice, the interest paid on individual mortgages has never been deductible for income tax purposes. As a result, there is a significant financial incentive to pay off the mortgage as quickly as possible because borrowers are using after-tax dollars.

A significant contribution

The establishment in 1946 of the Canada Mortgage and Housing Corporation with a mandate to provide mortgage insurance to Canadians made a significant contribution to the development of the housing market.

The significant recession and ultimate stagflation that occurred in 1981 and 1982 caused long-term interest rates to hit 18 percent on five-year mortgages and short-term interest rates to exceed 22 percent on individual six-month and one-year mortgages. At this point, very few borrowers were prepared to lock in interest rates for any significant length of time. As a result, the beginnings of a much shorter-term market developed in the early 1980s.

The average composition of the mortgage portfolios of most Canadian financial institutions today includes an average term to maturity of two to three years. As a result, there is a significant amount of renewal business, which many estimate totals $80 billion to $100 billion per year.

Limited prepayment rights

Unlike U.S. borrowers, Canadian borrowers do not have nearly as much flexibility in their right to repay a mortgage. Most of the mortgages written by the major financial institutions that are conventional (i.e., less than 75 percent loan-to-value) are technically closed; the borrower has no absolute contractual right to prepay the mortgage.

However, most Canadian banks and financial institutions are prepared to allow borrowers to prepay their mortgage, especially if they have sold their home subject to a significant interest penalty, which can often range from three to six months of interest. Most financial institutions make some provision to allow the borrower to prepay some specified amount on a per calendar-year basis (usually a range of 10 percent to 15 percent) without penalty.

The path of development

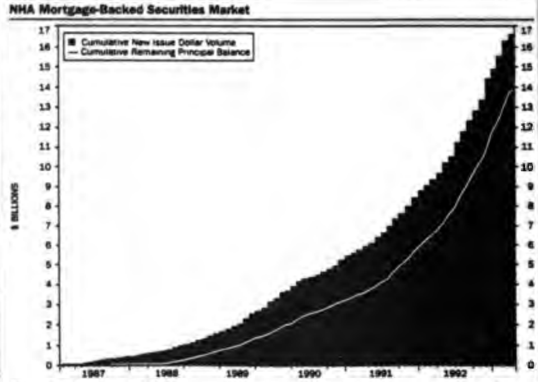
The development of the Canadian MBS market has been extremely slow in comparison with that of the United States. However, the Canadian MBS market began to grow rapidly from 1987 to 1993 (see Figure 1). Observing the successful development of the Government National Mortgage Association (GNMA) in the United States, it became clear that there were no unsurmountable legal impediments to the development of a secondary mortgage market in Canada. However, the caution of existing portfolio lenders to sell into the secondary market has contributed to the slowness of the development.

The government of Canada has tried many initiatives, including the 1973 incorporation of the Federal Mortgage Exchange Corporation. This entity was designed to stimulate and be a catalyst for the development of a secondary mortgage market.

The first publicly issued MBS in Canada was the Guaranteed Mortgage Certificate, issued by GMC Investors Corporation in late 1985. The security was an interesting hybrid of government-insured mortgages and timely payment guarantees supplied by Citibank Canada. The instrument was rated "double A (high)" by Dominion Bond Rating Service and subsequently as "AAA" by Canada Bond Rating Service.

FIGURE 1

NHA Mortgage-Backed Securities Market



Source: Burns Fry Limited, April 1993

Several years ago, the government of Canada announced in the budget of February 1984 that it would sponsor and initiate timely payment guarantees for MBS; however, the enabling legislation and the subsequent program were not established until early 1987.

The development of the federal government program through the Canada Mortgage and Housing Corporation (CMHC) was based on a model similar to the GNMA program in the United States. Under the Canadian version, all individual mortgages must be insured under the National Housing Act and the mortgages must be originated and serviced by a CMHC-approved lender.

Once the mortgages are put into homogeneous pools (similar maturities, similar interest rates, similar amortization periods, geographical diversification, etc.), the mortgages are pooled and securities are issued on the basis of an undivided interest in the pool. The process of paying the investors each month is carried out by a central payor and transfer agent (CPTA), a contract awarded to Montreal Trust Co. in 1986.

CMHC supplies a guarantee of the timely payment both of principal and interest on a monthly basis and of the total amount of the principal outstanding at maturity. As a result, each of these securities carries the full faith and credit of the Canadian government. Figure 2 shows the overall growth and newly issued securities, as well as the market share by issuer for the years 1987 to 1993.

There have been some interesting developments in the market outside of the CMHC MBS program. One such development has been the creation of the special-purpose trust established by Central Guaranty Trust that holds conventional mortgages and offers limited subordination for the purposes of passing through interest on a timely basis, as well as a full amount of the subordination up to a specific limit of 5 percent in the event of default on the individual mortgages.

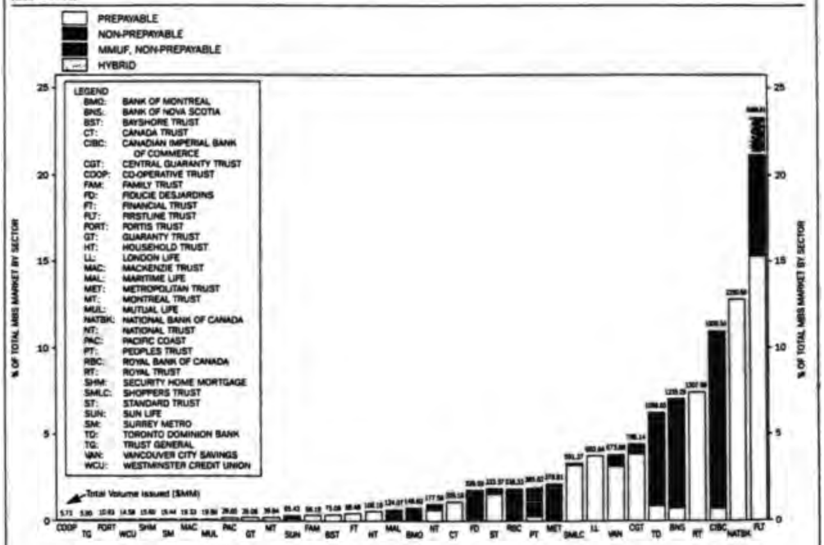
The FirstLine NHA Mortgage Trust has also been established as a specific-purpose trust with a mandate to purchase NHA-insured mortgages and fund them with a combination of commercial paper and midterm notes. The midterm notes carry a six-month payment of interest and no principal prepayment prior to the maturity date. The commercial paper is rated at an "R1 (high)" and the midterm notes are rated "Triple A" by both Canada Bond Rating Service and Dominion Bond Rating Service. Both Royal Trust and Van City Savings have also issued MBS, but mostly with some success in the Euro-Canadian bond market and limited distribution in Canada.

No Fannie or Freddie yet

Unlike the United States, Canada still has not developed a significant alternative to the CMHC program for the securitization of conventional mortgages. However, those issuers who are active players in the securitization market are currently absorbing the cost of the CMHC insurance premium on conventional mortgages in order to make them eligible for the CMHC MBS program.

FIGURE 2

NHA Mortgage-Backed Securities Market Share Distribution
(1987–1993)



Source: Burns Fry Limited, July 1993

CMHC charges a one-time insurance premium for the life of the loan that is based on the loan-to-value. The loan-to-value is considered a good indicator of risk levels and the insurance premium varies between 1 percent and 2.5 percent based on a range of loan-to-values from less than 65 percent to 95 percent.

Thus far, in a period of seven years, the Canadian MBS market has extended to approximately $16 billion in newly issued MBS, only a little more than 5 percent of the total value of all outstanding home mortgages. While the penetration of the mortgage market has been much slower than anticipated, the progress made so far is seen as a good indicator of a promising future.

It should be noted in passing that the Canadian government MBS is not subject to international withholding tax and, therefore, nonresident Canadian investors would not be subject to any Canadian withholding tax.

Recently the first CMO structures have been issued in Canada. Two CMO offerings totaling approximately $600 million were brought to market and the issuers were FirstLine Trust and the National Bank of Canada. With an upward sloping yield curve, this has been perceived as an effective execution of mortgage-backed securities.

Another particularly attractive aspect of a Canadian MBS for international investors is that it carries a zero percent risk-rating using the Bank for International Settlement standard for capital adequacy for international banks.

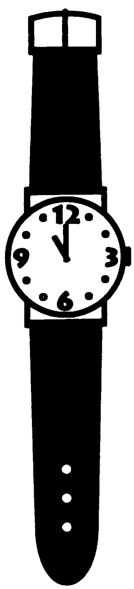
Two distinct markets

The development of the mortgage market in the United States has varied dramatically from that of Canada. This mostly traces to the restriction on developing national branch banking in the United States. As a result, the pace of development of national mortgage lenders was held back some and the mortgage business has remained highly fragmented. The recent trend of mortgage banking companies going public has clearly demonstrated the current capacity for national lending in the United States.

Canada, on the other hand, is extensively served by its five major banks—with approximately 10,000 branches among them—and two major trust companies. As a result, the Canadian mortgage business is highly concentrated: approximately 12 players make up the vast majority of the marketplace. This oligopoly has lead to significantly reduced competition in mortgage lending, especially in terms of pricing.

One interesting comparison between the U.S. and the Canadian mortgage markets is that historically Canadian default rates have been significantly lower than in the United States. For example, the Canadian default rate (defined as 90 days in arrears) for the fourth quarter 1992 was less than 1 percent on a national basis.

The U.S. MBS market was developed for entirely different reasons than the Canadian market, and yet the potential for the MBS market in Canada is significant. And even though the MBS market in Canada is developing in response to different stimuli, the net result to Canadian consumers would be very similar to the results enjoyed by American consumers: borrowers get lower interest rates, while investors get higher interest rates.



Potential to outgrow U.S. market

The Canadian MBS market has developed relatively slowly so far, mostly because of the reluctance of the existing large suppliers of mortgage money to sell their mortgages to institutional investors. However, a credible argument can be made that the ultimate share of the Canadian residential mortgage market that will be securitized will be even greater than in the United States. That argument rests on the following points:

- In the United States, the vast majority of mortgages have been 30-year, fixed-rate loans. As a result, those seasoned mortgages already written at a low interest rate would be almost impossible to securitize, because homeowners would have no incentive to trade them in for a new mortgage funded by MBS. The recent refi mania has obviously securitized much more of the market.
- Canadian mortgages, because of their much shorter duration, will all renew with their existing lenders at current market rates over the next five years. In fact, it is estimated that approximately $100 billion of mortgages renew each calendar year in Canada.
- A significant opportunity exists for Canadian MBS issuers to capture a significant portion of this market through aggressive marketing and pricing.
- The market for MBS in Canada is considerably broader than it is in the United States. This is so because in the United States the secondary market agency programs and the FHA are constrained by relatively low loan limits. The U.S. programs have always been intended for the low- and middle-income borrower, and as a result, the amount of the total U.S. mortgage market that can be securitized with government backing is significantly less than the total market. However, the private pass-through market in the United States does serve the jumbo nonconforming market increasingly well.
- In Canada, however, CMHC has followed a very enlightened view and has ensured that NHA insurance can apply on all Canadian residential properties, subject to certain underwriting criteria but without limit as to the size of the individual mortgage. These large mortgages, in turn, may be securitized using the CMHC MBS program. The public policy rationale for this is that the CMHC timely payment guarantee and the mortgage insurance fund are self-sustaining, and, therefore, the benefits of securitization—lower interest rates for consumers—should be made equally available to all Canadians.
- Another factor encouraging the securitization of mortgages in Canada is the very noncompetitive nature of the mortgage lending oligopoly that has arisen. Existing financial institutions that have large mortgage portfolios that roll over or renew on a very short-term basis are unlikely to cannibalize their own profit margins by offering interest rates to their renewal customers that are significantly lower than the existing market demands.
- Aggressive mortgage lenders in Canada who use MBS funding will continue to gain significant market share by offering interest rates lower than those of the existing players.

FirstLine Trust Company is a specific case in point. It has grown from $150 million of assets under administration in 1987 to more than $5 billion in 1993. During this period, its growth was fueled by averaging 30 basis points below every major bank and trust company in Canada for five-year mortgages. As a result, FirstLine enjoys approximately 30 percent of the MBS market.

Prospects for Canada's market

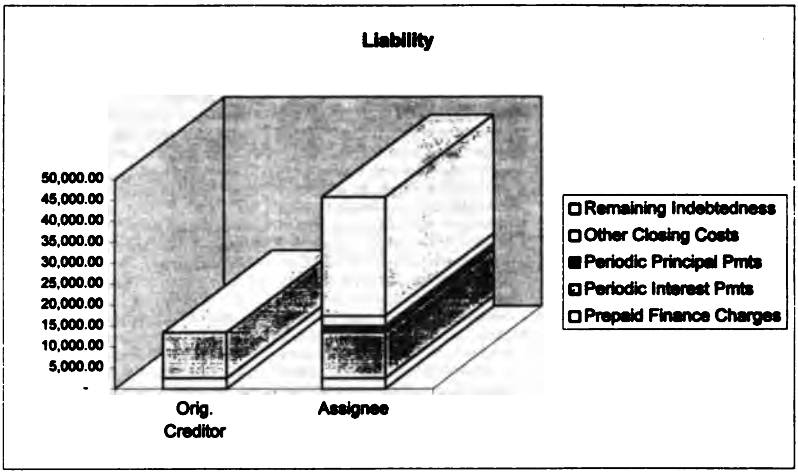
Estimations of the potential size of the MBS market in Canada vary dramatically depending on the underlying assumptions. Consistent with the competitive rate advantage that has been demonstrated so far by MBS issuers, capturing 25 percent to 30 percent of the ultimate market is certainly achievable during the next five to ten years. As a result, the market could develop to significantly more than $100 billion during the 1990s.

At some point, the capital-adequacy rules of the BIS will favor a strong emphasis on the off-balance sheet treatment available for MBS, and at that time, the major banks and trust companies will use MBS as an asset/liability tool to reduce interest rate risk and optimize capital allocation. MB

Ivan S. Wahl is chairman of FirstLine Trust Co. Based in Toronto, the company is a subsidiary of Manulife Financial.

APPENDIX B

HR 3153 Costs & Liabilities



Paid in Connection w/Transaction	Orig. Creditor	Assignee
Prepaid Finance Charges	2,450.00	2,450.00
Periodic Interest Pmts	10,974.93	10,974.93
Periodic Principal Pmts	-	1,621.47
Other Closing Costs	-	2,325.00
Remaining Indebtedness	-	28,378.53
Total Liability	13,424.93	45,749.93

HR 3153 Costs & Liabilities

Loan Amount	$ 30,000.00	
Interest Rate	15%	
Term	15 Years	
Payment	$ 419.88	
Closing Costs		
Loan Origination	1,500.00	*
Loan Discount	750.00	*
Appraisal	400.00	
Credit Report	65.00	
Tax Service	75.00	
Loan Processing	150.00	
Flood Certification	20.00	
Underwriting/Funding	200.00	*
Hazard Insurance	280.00	
Property Taxes	590.00	
Settlement/Closing	225.00	
Document Preparation	150.00	
Title Insurance	325.00	
Courier Service	15.00	
County Recording	30.00	
TOTAL	$ 4,775.00	

* Total Prepaid Interest $ 2,450.00

HR 3153 Costs & Liabilities

Payment Schedule

Date	Payment	Interest	Principal	Balance Due
Jan-94	419.88	375.00	44.88	29,955.12
Feb-94	419.88	374.44	45.44	29,909.68
Mar-94	419.88	373.87	46.01	29,863.67
Apr-94	419.88	373.30	46.58	29,817.09
May-94	419.88	372.71	47.17	29,769.92
Jun-94	419.88	372.12	47.76	29,722.16
Jul-94	419.88	371.53	48.35	29,673.81
Aug-94	419.88	370.92	48.96	29,624.85
Sep-94	419.88	370.31	49.57	29,575.28
Oct-94	419.88	369.69	50.19	29,525.09
Nov-94	419.88	369.06	50.82	29,474.28
Dec-94	419.88	368.43	51.45	29,422.83
Jan-95	419.88	367.79	52.09	29,370.73
Feb-95	419.88	367.13	52.75	29,317.99
Mar-95	419.88	366.47	53.41	29,264.58
Apr-95	419.88	365.81	54.07	29,210.51
May-95	419.88	365.13	54.75	29,155.76
Jun-95	419.88	364.45	55.43	29,100.33
Jul-95	419.88	363.75	56.13	29,044.20
Aug-95	419.88	363.05	56.83	28,987.37
Sep-95	419.88	362.34	57.54	28,929.84
Oct-95	419.88	361.62	58.26	28,871.58
Nov-95	419.88	360.89	58.99	28,812.59
Dec-95	419.88	360.16	59.72	28,752.87
Jan-96	419.88	359.41	60.47	28,692.40
Feb-96	419.88	358.66	61.22	28,631.18
Mar-96	419.88	357.89	61.99	28,569.19
Apr-96	419.88	357.11	62.77	28,506.42
May-96	419.88	356.33	63.55	28,442.87
Jun-96	419.88	355.54	64.34	28,378.53
	12,596.40	10,974.93	1,621.47	

6–1085

(d) If a consumer credit sale is one of a series of consumer credit sales transactions made pursuant to an agreement providing for the addition of the deferred payment price of that sale to an existing outstanding balance, and the person to whom the credit is extended has approved in writing both the annual percentage rate or rates and the method of computing the finance charge or charges, and the creditor retains no security interest in any property as to which he has received payments aggregating the amount of the sales price including any finance charges attributable thereto, then the disclosure required under subsection (a) for the particular sale may be made at any time not later than the date the first payment for that sale is due. For the purposes of this subsection, in the case of items purchased on different dates, the first purchased shall be deemed first paid for, and in the case of items purchased on the same date, the lowest priced shall be deemed first paid for.

[15 USC 1638. As amended by acts of March 31, 1980 (94 Stat. 178) and Dec. 26, 1981 (95 Stat. 1515).]

SECTION 129—[Repealed]

6–1086

SECTION 130 —Civil Liability*

(a) Except as otherwise provided in this section, any creditor who fails to comply with any requirement imposed under this chapter, including any requirement under section 125, or chapter 4 or 5 of this title with respect to any person is liable to such person in an amount equal to the sum of—

(1) any actual damage sustained by such person as a result of the failure;

(2)(A)(i) in the case of an individual action twice the amount of any finance charge in connection with the transaction, or (ii) in the case of an individual action relating to a consumer lease under chapter 5 of this title, 25 per centum of the total amount of monthly payments under the lease, except that the liability under this subparagraph shall not be less than $100 nor greater than $1,000; or

(B) in the case of a class action, such amount as the court may allow, except that as to each member of the class no minimum recovery shall be applicable, and the total recovery under this subparagraph in any class action or series of class actions arising out of the same failure to comply by the same creditor shall not be more than the lesser of $500,000 or 1 per centum of the net worth of the creditor; and

(3) in the case of any successful action to enforce the foregoing liability or in any action in which a person is determined to have a right of rescission under section 125, the costs of the action, together with a reasonable attorney's fee as determined by the court. In determining the amount of award in any class action, the court shall consider, among other relevant factors, the amount of any actual damages awarded, the frequency and persistence of failures of compliance by the creditor, the resources of the creditor, the number of persons adversely affected, and the extent to which the creditor's failure of compliance was intentional. In connection with the disclosures referred to in subsections (a) and (b) of section 127, a creditor shall have a liability determined under paragraph (2) only for failing to comply with the requirements of section 125, section 127(a), or of paragraph (4), (5), (6), (7), (8), (9), or (10) of section 127(b) or for failing to comply with disclosure requirements under State law for any term or item which the Board has determined to be substantially the same in meaning under section 111(a)(2) as any of the terms or items referred to in section 127(a) or any of those paragraphs of section 127(b). In connection with the disclosures referred to in subsection (c) or (d) of sec-

* Creditors choosing to comply with the amended statute and implementing regulations prior to October 1, 1982 are subject to the amended civil liability provisions. (Pub. L. 97-25 § 301).

tion 127, a card issuer shall have a liability under this section only to a cardholder who pays a fee described in section 127(c)(1)(A)(ii)(I) or section 127(c)(4)(A)(i) or who uses the credit card or charge card. In connection with the disclosures referred to in section 128, a creditor shall have a liability determined under paragraph (2) only for failing to comply with the requirements of section 125 or of paragraph (2) (insofar as it requires a disclosure of the 'amount financed'), (3), (4), (5), (6), or (9) of section 128(a), or for failing to comply with disclosure requirements under State law for any term which the Board has determined to be substantially the same in meaning under section 111(a)(2) as any of the terms referred to in any of those paragraphs of section 128(a). With respect to any failure to make disclosures required under this chapter or chapter 4 or 5 of this title, liability shall be imposed only upon the creditor required to make disclosure, except as provided in section 131.

6–1087

(b) A creditor or assignee has no liability under this section or section 108 or section 112 for any failure to comply with any requirement imposed under this chapter or chapter 5, if within sixty days after discovering an error, whether pursuant to a final written examination report or notice issued under section 108(e)(1) or through the creditor's or assignee's own procedures, and prior to the institution of an action under this section or the receipt of written notice of the error from the obligor, the creditor or assignee notifies the person concerned of the error and makes whatever adjustments in the appropriate account are necessary to assure that the person will not be required to pay an amount in excess of the charge actually disclosed, or the dollar equivalent of the annual percentage rate actually disclosed, whichever is lower.

6–1088

(c) A creditor or assignee may not be held liable in any action brought under this section or section 125 for a violation of this title if the creditor or assignee shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error. Examples of a bona fide error include, but are not limited to, clerical, calculation, computer malfunction and programing, and printing errors, except that an error of legal judgment with respect to a person's obligations under this title is not a bona fide error.

(d) When there are multiple obligors in a consumer credit transaction or consumer lease, there shall be no more than one recovery of damages under subsection (a)(2) for a violation of this title.

6–1089

(e) Any action under this section may be brought in any United States district court, or in any other court of competent jurisdiction, within one year from the date of the occurrence of the violation. This subsection does not bar a person from asserting a violation of this title in an action to collect the debt which was brought more than one year from the date of the occurrence of the violation as a matter of defense by recoupment or set-off in such action, except as otherwise provided by State law.

6–1090

(f) No provision of this section, section 108(b), section 108(c), section 108(e), or section 112 imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or interpretation thereof by the Board or in conformity with any interpretation or approval by an official or employee of the Federal Reserve System duly authorized by the Board to issue such interpretations or approvals under such procedures as the Board may prescribe therefor, notwithstanding that after such act or omission has occurred, such rule, regulation, interpretation, or approval is amended, rescinded, or determined by judicial or other authority to be invalid for any reason.

6–1091

(g) The multiple failure to disclose to any person any information required under this chapter or chapter 4 or 5 of this title to be disclosed in connection with a single account under an open end consumer credit plan, other single consumer credit sale, consumer loan, consumer lease, or other extension of consumer credit, shall entitle the person to a single recovery under this section but continued failure to disclose after a recovery has been granted shall give rise to rights to additional recoveries. This subsection does not bar any remedy permitted by section 125.

6–1092

(h) A person may not take any action to offset any amount for which a creditor or assignee is potentially liable to such person under subsection (a)(2) against any amount owed by such person, unless the amount of the creditor's or assignee's liability under this title has been determined by judgment of a court of competent jurisdiction in an action of which such person was a party. This subsection does not bar a consumer then in default on the obligation from asserting a violation of this title as an original action, or as a defense or counterclaim to an action to collect amounts owed by the consumer brought by a person liable under this title.

[15 USC 1640. As amended by acts of Oct. 28, 1974 (88 Stat. 1518); Feb. 27, 1976 (90 Stat. 197); March 23, 1976 (90 Stat. 260); and Nov. 3, 1988 (102 Stat. 2966).]

6–1093

SECTION 131—Liability of Assignees*

(a) Except as otherwise specifically provided in this title, any civil action for a violation of this title or proceeding under section 108 which may be brought against a creditor may be maintained against any assignee of such creditor only if the violation for which such action or proceeding is brought is apparent on the face of the disclosure statement, except where the assignment was involuntary. For the purpose of this section, a violation apparent on the face of the disclosure statement includes, but is not limited to (1) a disclosure which can be determined to be incomplete or inaccurate from the face of the disclosure statement or other documents assigned, or (2) a disclosure which does not use the terms required to be used by this title.

6–1094

(b) Except as provided in section 125(c), in any action or proceeding by or against any subsequent assignee of the original creditor without knowledge to the contrary by the assignee when he acquires the obligation, written acknowledgement of receipt by a person to whom a statement is required to be given pursuant to this title shall be conclusive proof of the delivery thereof and, except as provided in subsection (a), of compliance with this chapter. This section does not affect the rights of the obligor in any action against the original creditor.

(c) Any consumer who has the right to rescind a transaction under section 125 may rescind the transaction as against any assignee of the obligation.

[15 USC 1641. As amended by acts of March 31, 1980 (94 Stat. 182) and Dec. 26, 1981 (95 Stat. 1515).]

6–1095

SECTION 132—Issuance of Credit Cards

No credit card shall be issued except in response to a request or application therefor. This prohibition does not apply to the issuance of a credit card in renewal of, or in substitution for, an accepted credit card.

[15 USC 1641. As amended by act of Oct. 26, 1970 (84 Stat. 1126).]

6–1096

SECTION 133—Liability of Holder of Credit Card

(a)(1) A cardholder shall be liable for the unauthorized use of a credit card only if—

(A) the card is an accepted credit card;

* Assignees of creditors choosing to comply with the amended statute and implementing regulations prior to October 1, 1982 are subject to the amended civil liability provisions (Pub. L. 97-25 § 301).

CIMBA

SUMMARY STATEMENT
OF
GARY K. JUDIS
LEGISLATIVE CHAIRMAN
CALIFORNIA INDEPENDENT MORTGAGE
BROKERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON CONSUMER CREDIT
AND INSURANCE,
HOUSE COMMITTEE ON BANKING,
FINANCE, URBAN AFFAIRS
MARCH 22, 1994

California Independent Mortgage Brokers Association • 15130 Ventura Blvd., Suite 320 Sherman Oaks, CA 91403 • Telephone (213) 872-0265

DIS U.S. HOUSE SUMMARY OF TESTIMONY

MR. CHAIRMAN, MEMBERS OF THE SUB-COMMITTEE ON CONSUMER CREDIT AND INSURANCE, I AM GARY K. JUDIS, LEGISLATIVE CHAIRMAN OF THE CALIFORNIA INDEPENDENT MORTGAGE BROKERS ASSOCIATION, CIMBA. I AM ALSO CEO AND CHAIRMAN OF THE BOARD OF AAMES FINANCIAL CORP., A PUBLICLY HELD LOAN BROKERAGE FIRM.

I THANK YOU, MR. CHAIRMAN, FOR THE OPPORTUNITY TO TESTIFY.

WE HAVE PROVIDED COPIES OF MY COMPLETE TESTIMONY TO THE COMMITTEE. BUT I WOULD LIKE TO SUMMARIZE THAT TESTIMONY NOW. AT THE CONCLUSION OF MY SUMMARY I WILL BE HAPPY TO RESPOND TO QUESTIONS.

CIMBA IS A NON-PROFIT, PROFESSIONAL SOCIETY COMPRISED OF INDIVIDUALS AND FIRMS LICENSED AS REAL ESTATE BROKERS ENGAGING, PRIMARILY, IN THE PURSUIT OF MAKING AND ARRANGING REAL PROPERTY EQUITY LOANS ON BEHALF OF CALIFORNIANS.

I AM HERE TODAY BECAUSE MY ASSOCIATION BELIEVES THE AUTHORS OF H.R. 3153 ARE INTERESTED IN THE SAME GOAL AS WE ARE:

TO ELIMINATE, THE ABUSIVE LENDING PRACTICES OF THE FEW IN THE INDUSTRY WHO WOULD TAKE ADVANTAGE OF THE BORROWER, ESPECIALLY IN THE TIME OF GREAT STRESS, WITHOUT DISRUPTING THE FLOW OF FUNDS PROVIDED BY THE INDUSTRY THE VAST MAJORITY OF WHOM ARE HONEST AND CREDIBLE, AND WHO SERVE A VERY LEGITIMATE NEED TO HOMEOWNERS WITH EQUITY IN THEIR PROPERTY.

JUDIS REMARKS 2-2-2

WE UNDERSTAND THAT THERE HAVE BEEN ABUSES AND OUR ASSOCIATION RECOGNIZES THAT LAX, SOMETIMES NONEXISTENT, REGULATION HAS CREATED CAUSE FOR GENUINE CONCERN BY CONGRESS THUS THE INTRODUCTION OF H.R. 3153.

RECENTLY WE HAVE BECOME FAMILIAR WITH THE TERM "DISPARATE IMPACT" IDENTIFIED BY THE JUSTICE DEPARTMENT AS BEING THE RESULT OF WELL MEANING, PROCEDURES WHICH IN FACT PRODUCE PATTERNS OF LENDING THAT EXCLUDE EQUITY BORROWERS FROM ECONOMICALLY DISADVANTAGED NEIGHBORHOODS.

WHILE WE SUPPORT THE GOAL OF H.R. 3153 TO ELIMINATE ABUSES WE DO NOT BELIEVE THE MEASURE AS CONSTITUTED WILL ACCOMPLISH THAT OBJECTIVE WITHOUT CREATING "DISPARATE IMPACT" AMONGST THE PERSONS HOME EQUITY LENDING CAN BEST ASSIST.

IN CALIFORNIA WE HAVE DEVELOPED A WELL REGULATED SYSTEM OF REAL ESTATE LAW OVER ALMOST FORTY YEARS THAT PROVIDES PROTECTIONS FOR EQUITY BORROWERS - BUT IN SUCH A MANNER AS TO PRESERVE THE CONDUIT WHICH DISTRIBUTES THE FUNDS TO THOSE FAMILIES.

BEFORE DISCUSSING THIS IN GREATER DETAIL LET ME ADDRESS THE POINTS THAT YOU ASKED BE ADDRESSED, MR. CHAIRMAN.

JUDIS REMARKS 3-3-3

FIRST - IF TRIGGERS ARE TO BE RETAINED IN H.R. 3153 - WE WOULD RECOMMEND THEY BE AS FOLLOWS:

(1) THE INTEREST RATE AT CONSUMMATION OF THE TRANSACTION WILL EXCEED BY MORE THAN 12 PERCENTAGE POINTS THE THIRTY YEAR CONVENTIONAL FANNIE MAE FIXED RATE MORTGAGE; AND

(2) ALL PREPAID FINANCE CHARGES PAYABLE BY THE CONSUMER AS DEFINED IN REGULATION Z AT OR BEFORE CLOSING WILL EXCEED THE GREATER OF:

A. 12 PERCENT OF THE TOTAL LOAN AMOUNT; OR

B. $400.

SECONDLY, WE SUPPORT THE MEANS OF COMPUTING ANNUAL PERCENTAGE RATES OF INTEREST INCLUDING THE CERTAIN FEES THAT MAY BE EXCLUDED IN CALCULATION OF THE APR AS NOW CONTAINED IN THE TRUTH IN LENDING LAW.

JUDIS REMARKS 4-4-4

THIRDLY, CONCERNING DISCLOSURE I WOULD CALL TO YOUR ATTENTION ONE OF CALIFORNIA'S DISCLOSURE DOCUMENTS, THE MORTGAGE LOAN DISCLOSURE STATEMENT MANDATED BY THE STATE ON ALL EQUITY LOANS SECURED BY REAL PROPERTY. BROKERS ARE REQUIRED TO GIVE THIS DOCUMENT TO ALL BORROWERS AT THE TIME OF LOAN APPLICATION. IT DETAILS ALL ASPECTS OF THE LOAN THEY HAVE APPLIED FOR AND INCLUDES A PARAGRAPH NEAR THE TOP OF THE DOCUMENT THAT STATES AS FOLLOWS:

> "NOTICE TO BORROWER: IF YOU DO NOT HAVE THE FUNDS TO PAY THE BALLOON PAYMENT WHEN IT COMES DUE, YOU MAY HAVE TO OBTAIN A NEW LOAN AGAINST YOUR PROPERTY TO MAKE THE BALLOON PAYMENT. IN THAT CASE, YOU MAY AGAIN HAVE TO PAY COMMISSIONS, FEES AND EXPENSES FOR THE ARRANGING OF THE NEW LOAN. IN ADDITION, IF YOU ARE UNABLE TO MAKE THE MONTHLY PAYMENTS OR THE BALLOON PAYMENT, YOU MAY LOSE THE PROPERTY AND ALL OF YOUR EQUITY THROUGH FORECLOSURE. KEEP THIS IN MIND IN DECIDING UPON THE AMOUNT AND TERMS OF THIS LOAN."

AS YOU CAN SEE, WE IN CALIFORNIA MAKE EVERY EFFORT TO EXPLAIN THE RISKS OF TAKING A HOME EQUITY LOAN TO BORROWERS. WE FEEL THIS DOCUMENT ACCOMPLISHES THAT GOAL.

FOURTHLY, IN THE AREA OF PROHIBITIONS SUCH AS BALLOON PAYMENTS IT IS OUR POSITION THAT ANY DEVICE THAT ASSISTS THE HOME OWNER IN OBTAINING FINANCING IN A REASONABLE MANNER BASED UPON THE EQUITY HE OR SHE IS

OFFERING AS SECURITY SHOULD NOT BE REJECTED OUT OF HAND. IN MANY INSTANCES BORROWERS WHO ARE ABOUT TO LOSE THEIR HOMES IN FORECLOSURES -FORECLOSURES USUALLY GENERATED BY BANKS AND OTHER FINANCIAL INSTITUTIONS - ARE ASSISTED BY OUR MEMBERS WHO CREATE LOANS WHICH ENABLE THOSE PERSONS TO SAVE THEIR HOMES. OFTEN THE INCLUSION OF A BALLOON PAYMENT IS KEY TO THE DEVELOPMENT OF SUCH A LOAN THAT ENABLES A PERSON TO SAVE THEIR HOME. PLEASE APPRECIATE THAT IN MANY CASES THE BORROWER WANTS NONAMORTIZED PAYMENTS BECAUSE THEIR FINANCIAL CRISIS IS SUCH THAT THEY NEED TEMPORARY RELIEF FROM HIGH MONTHLY PAYMENTS.

FIFTHLY, AS A MATTER OF PRINCIPLE MY ASSOCIATION IS AGAINST ALL UNFAIR, DECEPTIVE AND EVASIVE BUSINESS PRACTICES BUT WE WOULD HAVE TO DISCUSS PRACTICES SPECIFICALLY TO DETERMINE WHETHER OR NOT ONE OR ANOTHER WOULD BE CONSIDERED UNFAIR, DECEPTIVE AND EVASIVE AS JUDGED BY REASONABLE PEOPLE.

SIXTH, OUR MEMBERS DO NOT MAKE OPEN END LOANS. THESE, I AM SURE THE COMMITTEE KNOWS, HAVE BECOME POPULAR IN THE LAST THREE TO FOUR YEARS.

WE SEE NO REASON WHY FROM THE REGULATORY CONSUMER PROTECTION STANDPOINT OPEN END LOANS SHOULD BE TREATED DIFFERENTLY FROM ANY OTHER LOANS.

JUDIS REMARKS 6-6-6

SEVEN, THE QUESTION POSED IN YOUR LETTER OF MARCH 15 TO ME CONCERNING THE RIGHT OF STATES TO SET LIMITS ON INTEREST, FEES AND OTHER TERMS OF NON-PURCHASE MONEY MORTGAGES LEADS INTO THE SYSTEM OF CALIFORNIA LAWS AND REGULATION THAT I REFERRED TO EARLIER.

FOR NEARLY FOUR DECADES CALIFORNIA REAL ESTATE LAW HAS TAKEN NOTE OF THE DIFFERENCE BETWEEN "SOPHISTICATED" AND "UNSOPHISTICATED" BORROWERS AND ESTABLISHED A SYSTEM TO SAFEGUARD THE LESS KNOWLEDGEABLE.

USING A DOLLAR MEASUREMENT, CURRENTLY THIRTY THOUSAND DOLLARS ON FIRST LIENS AND TWENTY THOUSAND DOLLARS ON JUNIOR LIENS, CALIFORNIA REAL ESTATE LAW HAS SET LIMITS ON COMMISSIONS, EXPENSES AND TERMS OF SUCH LOANS THAT ARE KNOWN AS "REGULATED" OR "SHELTERED" LOANS.

FOR EXAMPLE, NO SUCH SHELTERED LOAN WITH A MATURITY DATE OF LESS THAN SIX YEARS CAN CARRY A BALLOON PAYMENT.

ANOTHER LIMIT IS PLACED ON BROKER'S COMMISSIONS SO THAT ON A SHELTERED LOAN THE BROKER'S COMMISSION CANNOT EXCEED FIFTEEN PERCENT FOR A SIX YEAR LOAN AND NOT MORE THAN TEN PERCENT FOR A TWO YEAR LOAN. NOTWITHSTANDING THESE STATUTORY LIMITS, THE FACT IS THAT FOR UNREGULATED LOANS COMPETITION HAS CREATED MORE STRINGENT LIMITS. IN MY OWN COMPANY TODAY, THE AVERAGE COMMISSION STRUCTURE FOR UNREGULATED EQUITY LOANS IS APPROXIMATELY 9% AND MOST OF THESE LOANS ARE LONG-TERM FULLY AMORTIZED LOANS.

JUDIS REMARKS 7-7-7

EXPENSES ARE ALSO LIMITED. AS ECONOMIES HAVE CHANGED OVER THE YEARS THE AMOUNT THAT CAN BE CHARGED IN EXPENSES ON A SHELTERED LOAN HAS BEEN ADJUSTED TO ITS CURRENT LEVEL OF SEVEN HUNDRED DOLLARS.

IN THE AREA OF PREPAYMENT PENALTIES, OUR SYSTEM PROVIDES A LENDER RECEIVE SIX MONTHS OF UNEARNED INTEREST ON EIGHTY PERCENT OF THE

ORIGINAL BALANCE FOR SEVEN YEARS. THIS PROVISION ACCEPTS THE MARKETPLACE REALITY THAT AN EARLY PAYMENT PREVENTS A LENDER FROM REALIZING THE AGREED UPON RETURN ON HIS OR HER INVESTMENT AND IS SANCTIONED BY FANNIE MAE.

THERE ARE MANY MORE ASPECTS TO THIS ISSUE, MR. CHAIRMAN AND MEMBERS OF THE SUB-COMMITTEE, AND I WOULD BE HAPPY TO EXPAND ON MY STATEMENTS GIVEN HERE OR TO DISCUSS OTHER FACETS AND RAMIFICATIONS OF H.R. 3153 ON MY INDUSTRY.

THANK YOU FOR THE OPPORTUNITY TO APPEAR HERE TODAY.

# # # #

STATEMENT OF THE

AMERICAN FINANCIAL SERVICES ASSOCIATION

BEFORE THE SUBCOMMITTEE ON

CONSUMER CREDIT AND INSURANCE ON H.R. 3153,

'THE HOME EQUITY PROTECTION ACT '

MARCH 22, 1994

The American Financial Services Association appreciates this opportunity to express our views on H.R. 3153, "The Home Equity Protection Act ".

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional providers of financial services to consumers and small businesses. As adopted by our members, the mission of AFSA "is to assure a strong and healthy broad-based consumer lending services industry which is committed to (1) providing the public with a quality and cost effective service, (2)promoting a financial system that enhances competitiveness and (3) supporting the responsible delivery and use of credit and credit related products".

AFSA's members fit into four basic categories:

•Diversified Financial Services Companies -- These are companies that offer a broad range of financial services and products to middle income consumers nationwide. Many of these members are affiliated with banks or savings and loans.

•Automotive Finance Companies -- These companies are frequently referred to as "captive finance companies". They provide financing for customers that purchase

the manufacturer's products. In addition, many of the companies or their parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

•Consumer Finance Companies -- The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.

•Credit card issuers -- This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include some of the largest credit card issuers in the U.S.

Some consumer finance companies are owned by, own, or are affiliated with depository institutions, such as savings & loans, consumer banks (limited-purpose banks), or credit card banks. These institutions are fully regulated institutions, subject to all of the laws and regulations applying to banking institutions, including the Community Reinvestment Act and the Home Mortgage Disclosure Act. They are regularly examined by state and federal banking authorities.

In addition, each of these consumer lenders must comply with federal regulations relating to consumer credit - the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Truth in Leasing Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, and the Federal Trade Commission's Credit Practices Rule are among the most important.

Consumer lenders which are not depository institutions, are generally licensed and regulated by the state banking department or the department of corporations in every state in which they operate, often separately regulated for each product. They are subject to state usury laws governing the interest they can charge on consumer loans, as well as state consumer protection laws.

As the above demonstrates, AFSA members are important providers of credit to the American consumer. AFSA members are highly innovative and compete at all levels in the financial services markets. As reflected in our mission, our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

Summary of AFSA's Position

AFSA strongly supports the goals of H.R. 3153. It should go without saying that AFSA members are strongly opposed to any credit practices directed at particularly vulnerable consumers which are intended from the outset to deprive those consumers of their homes. It is highly appropriate that Congress move to eliminate this type of abuse, no matter how limited the class of lender or consumer. These types of practices have a negative impact on legitimate lenders as well as consumers.

AFSA is not concerned as to the consequences any legislation would impose on those who knowingly engage in substandard loan origination practices, but we are deeply concerned about government intervention in market pricing mechanisms, and therein lies one of our two main areas of reservation about H.R. 3153 as currently drafted. We have offered some constructive suggestions to help meet the subcommittee's laudable goal of taking steps to eliminate predatory lending practices, but remain focused on specific abuses.

Our threshold concern is with the pricing triggers and definitional section. The trigger provisions of the bill consist of two pricing terms, interest and points. If a loan meets either one of those triggers, it is deemed a "high cost mortgage". This results in the prohibition of certain substantive contractual terms in the loan agreement as well as the application of complete assignee liability. These prohibited contract terms are an important part of how many lenders price their loans and are

essential to retaining the ability to offer products to a wide variety of consumers who might not otherwise qualify for credit.

Our second concern is the regulatory burden that will be imposed on home equity lenders in view of remedial measures which were passed during the last Congress. The recent extension of the Real Estate Settlement Procedures Act to "subordinate" mortgages by the last Congress should ameliorate many of the problems which H.R. 3153 seeks to resolve. The effect of this major regulatory development on the entire second mortgage industry should be examined and its impact evaluated before imposing new obligations and restrictions on home equity lenders.

H.R. 3153 and Second Mortgage Abuses

The purpose of H.R. 3153, as we understand it, as based on hearings before your subcommittee and in the Senate, is designed to remedy abusive lending practices where a vulnerable class of consumers who possessed significant equity in their homes were targeted by third parties such as home improvement contractors. These individuals induced consumers to enter into disguised loan transactions that resulted in the unjustified loss of their residences through foreclosure. At least some of these loans were "hidden" in bulk packages of loans and sold to a limited number of lending institutions.

Characteristics of the finance contracts for the home repairs appear to have been high rates of interest, high prepaid finance charges, high prepayment charges, high broker fees, and balloon payments designed to trigger foreclosure. According to the victims who publicized their predicaments, only a relatively small amount of the proceeds of the loan would go to the borrower. In order for this practice to be profitable, customers were either required to pay the inflated or "padded" loans, or the homes in question must have had adequate equity cushions enabling them to be

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sold in foreclosure for a profit.

It was alleged that these mortgages were financed by a so-called intermediary lender and then the mortgages were "assigned," frequently on a "preapproved" basis to another lender.

H.R. 3153's Trigger Mechanism

The so-called "trigger" provisions of the bill consist of two pricing terms, interest and points. If a loan meets either one of those triggers, it is deemed a "high cost mortgage". This results in the prohibition of certain substantive contractual terms in the loan agreement as well as the application of complete assignee liability. These prohibited contract terms are an important part of how many lenders price their loans. For instance, a loan with a prepayment penalty may carry a lower rate. A loan with a balloon feature may carry a higher rate, but offer significantly lower overall payments; alternatively, a balloon payment loan may be a short term, higher rate "bridge loan" that buyers need when they close on a new house before they sell their old one.

The market has done an excellent job of meeting customer needs, devising many and varied products that carry a wide range of features and prices. While we know it is not the intent of the bill to deter legitimate lending, it is very difficult, if not impossible to avoid such a result when directly or indirectly regulating price. This point is illustrated in the New York State Banking Commission study on interest rate regulation in Appendix C of this statement. The study found that where rates were deregulated, the availability and variety of credit products increased significantly with major benefits to the consumer. The New York legislature, based on the study, and at the behest of Governor Cuomo, earlier this year enacted legislation completely deregulating interest rates.

It should be noted that many AFSA members make virtually no loans that would be affected by this bill. Many other AFSA companies, such as our credit card lenders and automobile finance companies make no such loans at all. It would be easy and more pleasant for these companies so situated to support or take no position on this bill, especially given the compelling nature of the abuses which spawned it. Yet virtually all AFSA members join in voicing our concern over this type of regulation.

In this vein, we respectfully recommend that if the subcommittee proceeds with legislation, it consider alternatives to the pricing triggers that would focus on the specific abuses or provide a more direct mechanism for the elimination of abusive mortgages.

If a trigger is necessary, a better choice would be an underwriting standard such as debt to income ratio. This is a vastly superior determinant of a borrower's ability to pay and hence retain his or her home-- it doesn't help for loan to have a low rate if a borrower is not capable of making the payments on the underlying obligation. We understand that insured institutions have a legitimate problem with this type of standard and an exemption for them is appropriate.

A still more appropriate approach is to change the focus of the bill from pricing to prohibit loans made at the outset with the intent to foreclose, which is the primary abuse giving rise to the bill. While H.R. 3153 has some language to this effect in new Section 129(g), we believe it can be more tightly drafted with regard to the characteristics of such loans. This is difficult but not impossible.

The approach that would provide the best result, in our opinion, would be to charge a federal agency with substantial mortgage lending expertise such as the Federal Reserve Board or HUD to engage in formal rulemaking to determine the characteristics of this type of mortgage, to which the statutory prohibitions and

penalties would then apply. The agency could be statutorily charged to consider a wide range of appropriate factors, with the whole process subject to Congressional oversight. Given the complexity and variety of lending products, this type of process would provide the expertise and flexibility necessary to avoid permanent disruption of second mortgage lending markets.

If the bill is appropriately targeted away from pricing and towards truly abusive lending practices, then it is highly likely that AFSA would have no problems with any of the substantive prohibitions or assignee liability.

If the pricing triggers are retained, then we have offered technical comments on the other provisions of the bill that are included later in our testimony. We understand that the Chairman is considering changes to a number of these provisions. As outlined to us, the changes under consideration are constructive and we appreciate your initiative in undertaking the changes. We have noted these potential changes where appropriate and made any further suggestions we think are useful. Of particular importance are your proposals to delete the provisions repealing federal interest rate preemption for non-purchase money first mortgages; changing the interest rate trigger to Treasury securities of a comparable maturity; increasing the fees and charges exempted from the points trigger; and limiting the application of the bill's provisions to only closed end second mortgage transactions.

Not addressed by the Chairman's proposed changes to the bill is the issue of assignee liability. H.R. 3153 would impose complete and substantial assignee liability on purchasers of these mortgages in the secondary market. This would mean that a purchaser of such a mortgage would be liable for <u>any</u> defects in the underlying mortgage. Current law imposes liability <u>only for defects that are apparent on the face of the instrument</u> (mortgage). There are considerable differences between purchasing mortgages and for example, credit card receivables or automobile loans. These obligations tend to consist of smaller balance, relatively homogeneous loans

whose underwriting quality can be verified through statistical sampling. Mortgages tend to be much larger in dollar amount with less commonality of terms and underwriting standards. To protect against liability, an assignee would have to attempt to verify all compliance matters on almost every loan in this category or a seller would have to provide substantial warranties and protections. In either case, the costs are essentially prohibitive and a meaningful secondary market in these types of legitimate mortgages would disappear.

New RESPA Requirements Should be Considered Before Imposing Substantive Requirements

The extension of the Real Estate Settlement Procedures Act (RESPA) to all subordinate liens (as required by Section 908 of the Housing and Community Development Act of 1992, Pub. L. 102-550) makes any additional requirements or prohibitions on home equity lenders a redundant regulatory burden. The application of RESPA will have a profound effect on the business practices of all home equity lenders. Before new regulatory measures and substantive prohibitions are mandated on this industry, prudence should dictate that the corrective legislation passed by the last Congress be permitted to go into effect, and its effectiveness evaluated..

The impact of these changes is so significant that AFSA submits that the current scrutiny of the second mortgage industry would not now be taking place if these RESPA changes had been in place during the past few years.

In prescribing regulations to implement Section 908, the Department of Housing and Urban Development cited House hearings in which it was highlighted that second mortgages were included within RESPA because of "the unfortunate potential for fraud and abuse among the elderly and inner-city homeowners". This purpose is nearly identical to that cited for H.R. 3153, which is being considered even <u>before</u> the new RESPA regulations have had a chance to go into effect.

RESPA applies to all "federally related mortgage loans" which includes home-improvement loans secured by first (including refinancings) or subordinate liens on residential real property which are made by any "creditor" as defined in the Consumer Credit Protection Act, who "makes or invests in residential real estate aggregating more than $1,000,000 per year". Also covered would be any dealer loan or dealer consumer credit contract originated with the intent of subsequent assignment of the dealer's interest to a lender.

RESPA takes a pragmatic approach of ensuring that all costs of a loan are disclosed to the consumer at the time of the loan application. Among the requirements that will apply to home equity lenders once the RESPA regulation becomes effective on August 9, 1994 are:

•Good Faith Estimate. Lender must provide good faith estimate of settlement costs to all applicants within three business days after application is received or prepared. Home equity lines of credit will not require the good faith estimate, due to the already extensive early disclosures provided for these loans under Regulation Z. The disclosure must also contain a statement regarding any required providers of a settlement service, and the lender's relationship with that provider, e.g. closing agent, appraiser, etc.. If an application is received by a mortgage broker who is not an exclusive agent of the lender, the mortgage broker must provide a good faith estimate within three business days, in addition to that provided by the lender.

•Settlement agents are required to use a HUD-1 or HUD-1A settlement statement for refinancing and junior lien settlements. This form itemizes each and every charge associated with the transaction in a manner that enables the borrower to examine the true details of the loan. Mortgage brokerage fees must be disclosed in the HUD form and good faith estimate if the broker is not the exclusive agent of the lender. This would include any fees paid by the lender as well and in "borrower pay" transactions. Regulation X also requires disclosure of brokers' fees in "table-funding" transactions.

•Loan Servicing: As a result of 1990 amendments to RESPA, lenders must disclose at the time of application (1) whether the servicing of the loan may be assigned, sold, or transferred at any time; and (2) a historical disclosure that includes the percentage of loans they have made in recent years that have experienced service transfers. HUD is currently revising Regulation X, and an interim rule continues to apply only to first mortgage liens including refinancings.

•Prohibition against Kickbacks and Unearned Fees: Under RESPA, no person shall give and no person shall accept any fee, kickback, or other thing of value pursuant to any agreement or understanding for the referral of a real estate "settlement service" in connection with a covered loan. Section 8(b) of RESPA prohibits any person from giving or receiving any part of a charge for a real estate "settlement service" in connection with a covered loan, except for services actually performed. Violations of these provisions can trigger both criminal and civil liability.

The extension of RESPA to all refinancings and subordinate loans (including all those which would be "high cost mortgages" under H.R. 3153) is far from a trivial, legalistic development. These requirements and prohibitions will have a profound effect on the second mortgage industry -- mostly in ways that should benefit the consumer. Consumers will receive even more disclosures, and will likely see some cost reductions due to the stringent prohibitions of Section 8. Broker compensation is likely to decline to reflect the actual services rendered by the broker.

As stated by the National Consumer Law Center, the new RESPA requirements will probably go a long way in curbing the type of second mortgage abuses cited in your hearings:

> "...{M}any of the second mortgage scams involve 'loan padding,' in which the loan includes exorbitant fees for the full array of closing costs - even when

unnecessary. Reg X gives a bow in that direction by giving HUD the authority to investigate high prices to see if they are caused by kickbacks or referral fees. While high prices standing alone are not proof of a RESPA violation, if these is no reasonable relationship to the market value of the goods or services provided, it may be considered that the excess is unearned and therefore a RESPA violation."
(NCLC Reports, Consumer Credit and Usury Edition, Jan./Feb. 1993)

The report goes on to say:

The settlement statement , in fact, helps close one of TIL's [Truth in Lending Act] loop holes. Since TIL does not mandate that consumers be given an itemization of the amount financed, some of the overreaching"As with Truth in Lending, RESPA provides consumers with important information. second mortgage lenders were able to conceal exorbitant costs and other forms of loan padding by providing simply a total amount financed. They should no longer be able to do that.
Moreover, the limitation on unearned charges and kickbacks, which carries the possibility of a maximum $10,000 fine as well as the treble-damages private remedy, gives advocates a handle on at least some of the loan padding technique used by these lenders."
(NCLC Reports, Consumer Credit and Usury Edition, Jan./Feb. 1993)

In a recent case also reported in the NCLC reports, the court noted the impact that RESPA will have on loan practices which have occurred and which have resulted in higher costs for consumers. In this case involving disclosure of brokers fees, Smith v. First Family, 1993 WL 344913, the court noted that a mortgage broker compensation practice being used by the lender would have had to be disclosed under RESPA if the new law requiring such disclosure had been in place at the time of the loan in question.

Although the new HUD rules will not become effective until August 9, 1994, many of our members have already made efforts to comply. Implementation of just the RESPA provisions will pose a major compliance burden on all subordinate mortgage lenders. Increasing them further through the enactment of H.R. 3153 would pose an extraordinary burden on this one industry. AFSA urges that full

consideration be given to the compliance burden placed on the industry by the new RESPA requirements and that the requirements of H.R. 3153 be weighed carefully against the new RESPA regulations.

Characteristics of the Modern Finance Company

AFSA is concerned that there is not a clear understanding of the structure of the modern finance industry and how it operates, especially vis a vis insured depository institutions. The finance industry has many unique characteristics which AFSA believes that the Subcommittee should consider if it moves forward with H.R. 3153. While AFSA represents primarily the consumer finance industry, it is necessary to look at the finance industry as a whole.

The modern finance industry consists of a varied group of financial institutions. Ownership is especially diverse, including: industrial and other nonfinancial companies, banks, non bank financial companies as well as independent finance companies. Many companies engage in both commercial and consumer finance. In 1990 the combined assets of the twenty largest firms totaled $426 billion or 82 percent of the industry's overall assets. Of the top twenty companies, twelve do both commercial and consumer finance.

In virtually all cases, finance companies carry significantly heavier capital burdens and do not have deposit insurance . In 1990, capital ratios for the top 20 companies ranged from a low of 8.4 percent to a high of 27.7 percent. Seventeen of the companies had capital in excess of the highest recent capital level for an insured institution of comparable size, which is 12. 3 percent. Capitalization for finance companies is at least partially dependent upon asset quality and size.

Finance companies traditionally concentrate on loans secured by tangible

assets and have the greatest success in niche markets where they are well established and have specialized expertise, whether it is in commercial aircraft leasing or second mortgage lending to consumers who would not meet insured institution underwriting standards.

This is why finance companies are generally not in head to head competition with banks, but instead compete by offering services that substitute for bank credit in markets not served by banks. Banks do not serve these markets not because they are somehow evil or uncaring but because they are federally insured institutions with a regulatory environment that tries to protect the deposit insurance funds by tightly controlling risks, and hence controlling types of lending.

This is as true for an activity such as equipment leasing as it is for second mortgage loans to individuals. These specialized niche markets place a premium or specialized information and practical experience which place new lenders at a disadvantage short of acquiring a finance company engaged in a particular niche. For an insured institution it is particularly difficult to overcome this lack of knowledge and experience. Federal bank examiners will not tolerate the rate of losses and attendant demands on capital that it frequently takes to enter one of these niche markets. Additionally, once in the market, lenders are still exposed to higher risks than regulators of insured depository institutions would deem prudent, especially in light of Congressional pressures in recent years.

While banks have a significant cost of funds advantage, finance companies are able to charge overall higher interest rates which reflect the greater risks in their markets. Overall, finance companies earn higher returns than banks, but not by a huge amount. In order to fund themselves competitively in the commercial paper market, these are the rates of returns that are required.

Specific Comments on H.R. 3153

AFSA is pleased that the Chairman has agreed to consider several major substantive changes to H.R.3153. We understand that the changes being considered are to:

- Limit the application of the bill's provisions to closed-end credit transactions only.

- Delete that portion of the bill which repeals Federal interest rate pre-emption for non-purchase money first mortgages.

- Tie the "trigger" for defining a mortgage as a "high-cost mortgage" to Treasury securities of comparable maturity to the loan involved, rather than a one-year Treasury security.

- For "high-cost mortgages, allow balloon mortgages for terms of six years or more, and allow refinancings with the original lender when the APR for the new loan is lower than for the original loan.

- In determining fees and charges subject to the 8% points and fees trigger, mortgage broker fees would be included, but fees for credit insurance and other items exempted under the Federal Reserve Regulation Z would not. The Federal Reserve would have discretion, where necessary, to include certain items as subject to the 8% trigger.

- Exempt reverse mortgages from coverage by the bill, provided certain disclosures were made.

Despite our disagreement with the fundamental premise of H.R. 3153 (using pricing to trigger substantive prohibitions in private contracts), all of the above changes represent significant progress in correcting some of the problems with the bill as introduced. We welcome these changes, yet remain concerned with several aspects of the legislation. These concerns are:

Prepayment Penalties and Rebates

H.R. 3153 contains a number of substantive prohibitions -- most of them in areas which have traditionally been the province of state legislatures or regulators. Prepayment penalties, rebate computations, and refinancing costs are all price-related areas that have been considered by most states within the context of their consumer regulatory structures.

Prepayment penalties are not inherently abusive; to the contrary, they compensate the lender for costs incurred in originating the loan. Lenders do not make a profit on loans during the first year, based on the reality of proper accounting. The lender has fixed costs associated with every transaction, whether or not it ultimately goes to closing. The earned interest in approximately the first year does not equal those costs, including the accounting practice of booking the entire loan loss reserve at the time you put the loan on the books. Each lender identifies a percentage which represents its average loss for loans with similar risk characteristics, and charges itself that full amount when the transaction is booked.

Lenders often protect against operating losses due to refinancings and prepayments by including a reasonable prepayment penalty for usually just the first year or two. High rate loans are high risk loans. The rate charged to the consumer reflects the risk, so the loss reserve is greater. Therefore, to reflect these economic realities, AFSA would recommend eliminating the prepayment prohibition or, at the

very least, allow prepayment penalties during the first 18 months of the loan.

Rebate computations are also a traditional area of state purview. By restricting rebates to the actuarial method using simple interest, H.R. 3153 would effectively outlaw the Rule of 78's on so-called high cost mortgages. This is an area in which the last Congress legislated by reaching a compromise in banning the Rule of 78's for loans with maturities of over 61 months. (Section 933 of the Housing and Community Development Act of 1992). AFSA believes that the impact of compromise reached in the last Congress should be observed before implementing further restrictions.

In the event that the current approach is retained, the statement in new Section 129(c)(1) that a consumer is entitled to a rebate, is overbroad. When read literally, the section requires a rebate to the consumer in all circumstances, even where, for example, simple interest is already provided for in the contract. We recommend deletion of the language "the consumer is entitled...", and specify merely that any rebate (if applicable) be calculated in a manner no more costly than that provided under the simple interest method.

Balloon Payments

The prohibition of balloon payments represents one of the more baffling limitations on a home equity borrower's options. AFSA believes that balloon payments are a perfectly legitimate financing option, and are in fact utilized in many mortgage products sponsored by governmental sponsored agencies such as Fannie Mae and Freddie Mac. Even the change mentioned above to allow balloon payments on loans with terms of six years or more will impair a consumer's ability to utilize a very appropriate financing mechanism when used under the right circumstances.

Our members have brought to our attention several situations in which they have incorporated balloon payment features in their loans to the true benefit of the borrowers who utilized them. While not all of the following situations would necessarily be covered by the legislation, each illustrates (as does the example in the enclosed Washington Post article) that balloon payments can be successfully employed by knowledgeable borrowers. The following are a few of the situations which have been reported by our members:

•A building contractor had a piece of land that he wanted to offer as security. While he planned to build on it in the next few years, he needed some cash flow to take care of some immediate expenses. His credit and income were excellent. Other than the property he would have qualified for a loan with a bank very easily. The lender extended him a loan for period of two years with a balloon payment.

•A married couple owned a restaurant which was free and clear of any liens and also happened to be vacant. They wanted a loan so they could make improvements to the restaurant and then list it for sale. Again, except for the property, these people would have been very qualified to deal with a bank. The lender made them a loan for a period of five years with a balloon payment.

•A former borrower went to the lender because she needed a loan quickly, which she thought would be possible because the lender already had all of her records. She was selling her home but had a judgment still owing on it for approximately $27,000. The holder of the judgment had offered her some months before to reduce the figure to $20,000 if she could pay him by a certain date. She discovered that her escrow would close beyond that time and thus sought a loan. The lender was able to get the loan completed and funds to the holder of the judgment by the date agreed upon. While the loan was written for a period of six months, the lender was paid off twenty one days later when

her escrow closed. The borrower would have qualified for a bank loan, but chose the finance company because of her time constraints. The borrower's savings in this instance far exceeded the costs of the loan.

•A retired couple, living on a fixed income, had over-extended themselves with credit card and department store debt. While they had kept their credit in good standing they found that they could not qualify for a loan with a bank because of their income to debt ratio. Their home had more than enough equity to borrow against, and they planned to sell it but needed time to do so. The lender was able to make a loan to them to clear up all of their debts and give them additional time until their home was sold. The loan was written for a two year period with a balloon payment.

Each of these borrowers were looking for different things, yet each was interested in obtaining quick convenient service and a loan that offered a low monthly payment. The balloon payment was a crucial feature to the success of each of these loans. Through the cautious use of the balloon payment, these borrowers were able to save something that was important to them--whether it was money, their investments, or their credit standing. Obviously, in each of these cases, the lender was interested in the borrower's ability to make the balloon payment when it became due. The wise and considered use of a balloon payment feature in some situations can make the difference in the lives of some consumers--its ban is thoroughly unjustified.

AFSA urges reconsideration of the bill's ban on balloon payments. This loan feature is not inherently abusive. We do acknowledge however that the balloon payment feature is not an appropriate option for all borrowers. The borrower should be thoroughly aware of this terms if it is part of the loan agreement. Any substantive provisions aimed at balloon payment features should be targeted at abuses, particularly those which are direct causative factors in foreclosures on borrowers'

homes. A disclosure approach is certainly more appropriate for the balloon payment.

Other Concerns

Use of the term "high cost mortgage" and required warning statement (§ 2(a)) - While we understand that the sponsors of H.R. 3153 may wish to stigmatize a class of loans which possess certain pricing features, we believe that the use of the term "high cost mortgage" is unnecessarily pejorative in nature. Such a characterization obviously will have a stifling effect on the development and marketing of new loan products as lenders look for ways to avoid having their loans characterized as being "high cost" by the federal government.

The requirement to provide a statement: "Under Federal law, this is a high cost mortgage. You may be able to obtain a less expensive loan" is clearly an effort to stigmatize these loans right out of the market. We urge that the use of a pejorative term for these mortgages and the requirement for the warning statement be eliminated from this legislation. Consumers should be permitted to make their own determinations on the appropriate price to pay for loan products. In those cases where the market has faltered, the states have done an excellent job at deciding the appropriate limit on rates and fees that may be charged to consumers.

Required verification of consumer's income (New Section 129(a)(3)) - The bill requires that the creditor disclose the consumer's gress monthly cash income, as verified by the creditor. This requirement imposes an unduly burdensome requirement on lenders, and is unnecessary to effectuate the intent of the legislation.

Lenders should be able to set their own lending criteria and underwriting standards. Mandating that the creditor verify that the consumer is telling the truth when providing an income statement may provide the basis for better lending decisions, but is an otherwise deleterious intrusion into the relationship between the borrower and the lender. Additionally, the burden of identifying all sources of income

to the consumer, including salary, tips, interest from deposits and other investments, would be excessive. Lenders should be permitted to exercise their own judgment in making loan decisions based on the borrower's overall credit history and the size of the loan. We urge that this requirement be eliminated.

Civil Liability: Damages (§4) - In accordance with the rest of the Truth in Lending Act, we urge that the civil liability damages section of the bill include an exception for non-material violations.

Effective Date: The bill's effective date should be consistent with the Truth in Lending Act's requirement that requires that new regulations have an effective date of October 1 which follows by at least six months the date of promulgation.

Conclusion

The closed-end second mortgage industry is far from an under-regulated business. Numerous federal and state laws and regulations exist to protect consumers and to rein in unscrupulous lenders.

With the pending application of RESPA to the second mortgage industry, AFSA feels that the abuses which prompted this legislation would have been far less likely to occur.

We urge the Subcommittee to narrow the focus of the bill and will make every effort to cooperate in achieving the best result. We have made a number of constructive recommendations to focus the bill on particular areas of concern for consumers, and we hope to work with the Subcommittee to achieve its goals.

APPENDIX A

THE NATION'S HOUSING

Crackdown on Unscrupulous Lenders Would Be a Double-Edged Sword

By Kenneth R. Harney

New bills pending in the House and Senate would crack down on con-artist lenders who trick homeowners into signing up for double-digit mortgage rates and crushing fees at closing. But the same bills also could have a drastic side-effect: The outlawing of legitimate forms of mortgages, including bridge loans and balloon-payment loans, that thousands of homeowners nationwide use successfully.

The companion bills are sponsored by Rep. Joseph P. Kennedy II (D-Mass.), chairman of the House consumer credit subcommittee, and by Sen. Donald W. Riegle Jr. (D-Mich.), chairman of the Senate Banking Committee. Both measures grew out of hearings that documented "reverse redlining" by lenders who target vulnerable homeowners, and then rate-gouge them into foreclosure. The victims frequently are cash-strapped elderly persons or financially unsophisticated borrowers.

For example, one 72-year-old woman described at the Senate hearing how she was duped into a $150,000 "home improvement" loan by a door-to-door solicitor. The prepaid fees charged by the lender at closing exceeded $23,000. The payment due on the mortgage every month was larger than her entire gross monthly income.

To prevent abuses such as this the two bills would create a new category of home loan under the federal Truth-in-Lending statute—"High Cost Mortgages"—with tough new restrictions on all lenders who offer them.

High-cost mortgages are defined as any loan secured by a consumer's principal dwelling in which either the annual percentage rate exceeds one-year Treasury bills by more than 10 percentage points (a rate of about 13.5 percent at present), or carries fees payable to the lender by the borrower that are higher than 8 percent of the loan amount, or $400, whichever is greater.

The bills would force lenders to warn applicants for such loans that they could lose their homes if they fall behind on payments. A new disclosure required to be delivered in writing no later than three days before settlement would tell applicants that they still could bail out of the deal, and might be able to find better loan terms elsewhere.

The two bills would go far beyond disclosure, however. They would ban outright the use of balloon-payment plans on any loans that fall within the federal definition of a high-cost mortgage.

Balloon-payment loans involve deferral of portions of principal or interest until the final lump-sum payoff of the mortgage. Both the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac) offer popular low-rate balloon mortgages in which monthly payments are computed according to a 30-year amortization schedule, but the lump-sum final (balloon) payoff is due five or seven years after closing. The 30-year amortization allows monthly principal and interest payments by the borrower to be significantly lower than they would be on a standard five- or seven-year amortization.

In practice, the balloon payment due from the homeowner at the end is usually paid off via refinancing into another loan, either from the original or a different lender. In the case of Fannie Mae's and Freddie Mac's balloon programs, borrowers can either choose to pay off the debt in full at year five or seven, or roll over the debt into a loan extension, which may carry a higher rate than the original.

Balloon-payment programs often involve two other concepts that the new bills would prohibit on high-cost mortgages: "negative amortization" (deferral of interest by the lender), and "interest-only" payments (deferral of all principal until the final lump-sum payoff). Proponents of the bans say these payment methods are almost invariably employed in high-rate, high-fee loans that rip off unsuspecting borrowers.

But here's the problem: The same concepts are also commonly found in mortgages for homeowners with temporary credit problems caused by loss of jobs, deaths of spouses, divorce, or business failures by the self-employed. So, too, for bridge loans used by creditworthy home buyers facing an "equity gap": They need to close on a new house before they sell their existing home.

Loans such as these typically are short-term, feature balloon payments, and have annual percentage rates that would fit the new federal definition of "high cost." The borrowers involved tend to be aware of what they're signing up for. They'd prefer to be paying lower rates, but given their financial situations, they've got little or no alternative in the conventional mortgage market.

Take the case of a Danville, Calif., businessman who contacted a local mortgage broker for help last spring. The businessman, who requested anonymity, faced imminent foreclosure by a bank on his home after a series of business reverses. No conventional lender would extend him credit. The mortgage broker, however, arranged a 12-month, $270,000 balloon note carrying a rate of 13.75 percent. The interest-only repayment terms enabled the borrower to get his business affairs back in order and qualify for a new conventional mortgage, which he obtained in September.

The borrower's "high cost" mortgage would have been illegal under the terms of the pending bills. So would large numbers of bridge loans used by home buyers and sellers, which typically are short-term but carry effective annual percentage rates in the mid-to-upper teens.

The upshot? Both bills are moving ahead in their respective legislative bodies. Proponents say that while they're "sympathetic" to borrowers such as the California businessman, they plan no immediate amendments.

Washington Post 11/13/93

The Washington Post
Saturday, November 20, 1993

NATION'S HOUSING

Lenders Seek Ways to Curb Refinancings

By Kenneth R. Harney

Home buyers and refinancers across the country may soon get an important choice from major lenders when they apply for a mortgage: Either discounted interest rates or lower closing fees, in exchange for accepting a "prepayment penalty" clause designed to discourage refinancing during the early years of the loan.

The nation's largest mortgage banking firm, Countrywide Funding Corp., recently said that it is gearing up a discounted-rate prepayment-penalty plan for introduction early in 1994.

Other large lenders, such as Bank of America Corp., either already have launched programs or are actively considering doing so. One high-volume mortgage lender expects to offer loans in which all origination and closing fees that are normally charged the borrower are instead deferred. If the mortgage isn't refinanced in the first five years, the deferred fees, which typically amount to several thousand dollars or more, would be forgiven—wiped off the borrower's slate.

If, on the other hand, the borrower refinanced during that period, the fees would be included in the payoff amount owed to the lender.

The sudden surge of interest in prepayment clauses is the result of this year's refinancing boom. Mortgage companies that had counted on steady profits from their long-term "servicing" rights on loans have found their income streams disrupted by the heavy refinancing turnover. Investors in mortgage securities who had expected many years' of interest payments at above-market rates have ended up

See HARNEY, B6, Col. 3

NATION'S HOUSING

BARNEY, From E1

holding the bag when refinancing borrowers bailed out en masse of their 8 percent or 9 percent loans.

To bring greater stability and predictability to this market, lenders are looking to a classic free-enterprise solution, the quid pro quo: Give us a minimum of three or five years, and we'll knock one-fourth of a percentage point off your rate for the entire term of your loan. Or we'll provide you some other financial inducement, like lower fees.

"We think that a lot of people will recognize that this is a good deal for them," said Kevin Bartlett, executive vice president of Countrywide, based in Pasadena, Calif. The firm is active in all 50 states and has originated more than $30 billion in home mortgages during the first nine months of this year.

Bartlett said Countrywide would consider offering loans with prepayment penalties "tailored to the specific laws" of each state where prepayment clauses are permitted. For example, in California, the new loan option might offer up to one-fourth of a percentage point discount off the regular note rate, in exchange for a no-refinancing penalty, Bartlett said. California law would permit a penalty of up to six months worth of interest on the amount prepaid in the first five years, he said.

On a hypothetical $200,000 fixed-rate, 30-year loan in a 7 percent market, for instance, Countrywide might offer a prepayment-penalty option loan at 6.75 percent. The rate differential would knock the monthly principal and interest payment down from $1,330.61 to $1,297.20—a saving of $33.41 every 30 days, or about $400 over a 12-month period. The

differential would save an average borrower remaining in the property for seven to 10 years at least several thousand dollars compared with a full-priced 7 percent mortgage.

On the flip side, however, there would be a stiff penalty imposed on a borrower who refinanced in the first several years. The full, statutory six months worth of interest during the first year would exceed $6,500—a major disincentive. Countrywide has not decided yet on precisely what mix of incentives and disincentives to offer in its upcoming program. Participating borrowers would receive detailed disclosures of the potential benefits and costs at the application stage.

A different model aimed at achieving the same result is being worked on in Seattle. Washington Mutual Savings Bank's vice president for real estate lending, Joe Ebner, said his institution might offer "zero point" mortgages with prepayment-penalty clauses. Rather than collecting a standard two points (2 percent of the loan amount) in cash from borrowers at closing, the bank might charge borrowers no fees up front. If the customer didn't refinance during the next five years, the fees would be crossed off the books. Otherwise they would be payable in full.

One interesting wrinkle in this plan: Borrowers opting for the zero-point, prepayment-penalty concept would pay a lower interest rate than customers choosing standard zero-point loans without prepayment penalties. Standard zero-point borrowers, for instance, might pay 7.75 percent for a loan this month. Borrowers under the new, prepayment-penalty option would get a 7.125 percent note rate.

What if a lender offers you such an option the next time you apply for a mortgage?

Here are a couple of practical guidelines:

- If you have any doubt whatsoever that you might want to refinance in the coming three to five years, or if you think rates might fall further, don't risk the penalty to get the lower rate or fees.
- But if you feel there's a strong chance you can pass the three- or five-year test and you're comfortable with the risk, why not save the money? Just make sure you know what you're signing up for—the best scenario and the worst.

APPENDIX B

6506 Federal Register / Vol. 59, No. 28 / Thursday, February 10, 1994 / Rules and Regul

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Office of the Assistant Secretary for Housing—Federal Housing Commissioner

24 CFR Part 3500

[Docket No. R-94-1683; FR-3362-F-01]

RIN 2502-AG13

Amendments to Regulation X, the Real Estate Settlement Procedures Act Regulation (Subordinate Liens)

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Final rule.

In the final rule, a dealer loan or dealer consumer credit contract originated with the intent of subsequent assignment of the dealer's interest is defined as a "federally related mortgage loan." (See definition in § 3500.2 of "federally related mortgage loan".) The dealer advances credit to the borrower based upon the lender's prior agreement to fund the loan upon completion or delivery of goods and services, with the net proceeds to be paid to the dealer. The lender to whom the advance of credit is initially assigned is defined as a lender for purposes of this rule. The initial assignment of a dealer loan is not exempt from RESPA as a secondary market transaction, and the funding lender is responsible for: (i) Assuring that the necessary disclosures, such as the good faith estimate, are made in a timely manner, by either the funding lender or the dealer; and (ii) the use of the HUD-1 or HUD 1-A settlement statements.

A "dealer loan" or "dealer consumer credit contract" describes, generally, any arrangement in which a dealer assists a borrower in obtaining a loan from the funding lender, the dealer's interests are assigned to the funding lender, and the dealer receives the net proceeds of the loan. A loan or advance by a dealer in which the dealer does not assign its interest and receives the loan payments directly would not be a covered RESPA transaction, unless the dealer qualifies as a creditor as defined under the definition of a "federally related mortgage loan".

The Department was guided in these determinations by the Committee Report language regarding the amendments in the 1992 Act. The report stated in relevant part:

The Committee included second mortgages within RESPA because of the unfortunate potential for fraud and abuse among the elderly and inner-city homeowners. The Committee heard disturbing testimony at a May, 1991, hearing in Boston that indicated some secondary [sic] mortgage lenders, home-repair specialists and banks had allegedly taken advantage of elderly and minority homeowners * * *. The Committee believes that some homeowners might have been spared foreclosure and bankruptcy if comprehensive RESPA disclosures had been required during the negotiation process and if the anti-kickback provisions had been in place. (Report 102-760, of the Committee on Banking, Finance and Urban Affairs, House of Representatives to accompany H.R. 5334, July 30, 1992.)

A new Illustration 13 of appendix B further discusses a dealer loan transaction.

14. Appendix B to part 3500 is amended by adding illustration 13 at the end of the appendix, to read as follows:

Appendix B to Part 3500—Illustration of Requirements of RESPA

* * * * *

13. Facts. A is a dealer in home improvements who has established funding arrangements with several lenders. Customers for home improvements receive a proposed contract from A. The proposal requires that customers both execute forms authorizing a credit check and employment verification, and, frequently, execute a dealer consumer credit contract secured by a lien on the customer's (borrower's) 1- to 4-family residential property. Simultaneously with the completion and certification of the home improvement work, the note is assigned by the dealer to a funding lender.

Comments. The loan that is assigned to the funding lender is a loan covered by RESPA, when a lien is placed on the borrower's 1- to 4-family residential structure. The dealer loan or consumer credit contract originated by a dealer is also a RESPA-covered transaction, except when the dealer is not a "creditor" under the definition of "federally related mortgage loan" in § 3500.2. The lender to whom the loan will be assigned is responsible for assuring that the lender or the dealer delivers to the borrower a Good Faith Estimate of closing costs consistent with Regulation X, and that the HUD-1 or HUD-1A Settlement Statement is used in conjunction with the settlement of the loan to be assigned. A dealer who, under § 3500.2, is covered by RESPA as a creditor is responsible for the Good Faith Estimate of Closing Costs and the use of the appropriate settlement statement in connection with the loan.

APPENDIX C

A STUDY OF DEREGULATED INTEREST RATES ON CONSUMER LOANS

by

ERNEST KOHN

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BERNARD KAYE

New York State Banking Department
JANUARY 1993

II. SUMMARY AND CONCLUSIONS

Summary of Major Findings

The major findings of this study were the following:

1) Interest rates charged by financial institutions on most types of consumer loans increased between 1987 and 1990 and have declined since then.

2) Credit unions charged lower rates, on average, on most types of loans than did other types of financial institutions, while licensed lenders and retail stores charged the highest rates.

3) From 1987 to 1992, there has been a wide range of rates available for every type of loan in every major metropolitan area in New York State, thereby providing consumers with alternative choices which they can take advantage of by shopping for credit.

4) Many institutions increased the availability of credit to consumers since 1987 by introducing new types of consumer loan products, particularly home equity lines and credit cards, increasing credit lines, extending loan repayment periods and reducing down payment requirements for various types of loans.

5) Interest rates on credit cards declined much less, on average, in recent years than rates on most other types of consumer loans. However, these rates represent unweighted averages of the rates for all responding banks. They therefore do not adequately reflect the effects of the substantial rate reductions in 1992 by those banks with the largest number of credit cards and the largest dollar volume of credit card balances outstanding.

6) The credit card market has been characterized by

intensified competition in recent years as nonbank entities (GE, GM, Ford, A T & T, American Express and GTE) have begun offering credit cards at rates well below those charged by the large bank issuers.

7) Credit card profitability nationwide has declined in recent years although it is still much higher than the profitability on banks' total assets.

8) There are only four institutions that offer credit cards issued from New York State without a grace period, all of which charge a lower rate, or no annual fee, on the no-grace-period cards than on their grace period cards. Eight other institutions charge late payment fees on credit cards issued from New York without a 10-day grace period after the due date.

The detailed findings of the survey are set forth in Section III of this Report.

<u>Conclusions</u>

This survey indicates that interest rates on most types of consumer loans have declined significantly over the last several years and the largest bank issuers of credit cards have reduced rates for many of their customers during 1992. Moreover, interest rates on all types of consumer loans, including credit cards, vary substantially among different institutions in the same market area. Consumers are therefore able to choose among a wide range of rates for every type of loan in every major metropolitan area in New York State.

In addition, the credit card market has been characterized by intensified competition as nonbank entities have begun offering credit cards in recent years at rates well below those charged by the large bank issuers. For example, the rate on General Electric's credit card is 14.9% for the most creditworthy customers and 18.4% for others; General Motors 16.4% for all cardholders; Ford Motor 15.4% and 18.4% depending upon the amount charged on the card; A T & T 14.9% for charter members and 15.9% for others; American Express has three rates -- 12%, 14.25% and 18.25% -- depending upon the cardholder's payment history, amount charged on the card and whether they are new or previous cardholders; GTE with a 6% introductory rate assuming the prime rate remains at 6%, which will change to prime plus 10.4% on May 1, 1993; and the AFL-CIO card for union members at 11%.

These developments, together with the sharp declines in banks' cost of funds and concerns about possible imposition of Congressional limitations on credit card rates, have brought about substantial reductions during 1992 in rates charged by banks for many of their customers. Thus, Citibank's rates for cardholders with good payment histories and large credit card balances are currently 13.4% to 15.4% while Chase Manhattan's rates for such cardholders range from 13.4% to 14.4%. Chemical's fixed rata basic card has been reduced from 19.5% to 17.8% and its premium card rates are currently 15.0% and 16.8%; Fleet Bank's rate is 11.9% until January 31, 1993 and will be prime plus 8.4% thereafter; Bank of New York's rate is 11.9% without a grace period and 15.9% to

16.98% with a grace period.

While these credit card interest rates are higher than rates on other types of consumer loans, this reflects the facts that credit card extensions are unsecured; there are numerous transactions of relatively small size resulting in high handling and processing costs per dollar of loan; credit and fraud losses are higher than for other loans; and banks earn no interest on the 25-30% of all cardholders who pay off their balances in full during the grace period.

A major criticism of banks has been that their credit card rates have not been sensitive to the sharp declines in banks' cost of funds over the past several years. In evaluating this charge, it must be noted that funding costs are less than half of the total costs involved in credit card operations. A recent estimate of a representative cross-section of Visa and MasterCard issuers indicated that, in 1991, cost of funds represented 44% of total costs; credit losses, 29%; and operating expenses, 26%. On the earnings side, about 76% came from interest income, 7% from annual fees, 3% from penalty fees and 13% from other income.[4] Another survey by the Federal Reserve of a sample of small- and medium-size banks indicated that cost of funds was 27% of total costs in 1991; credit losses, 15%; and operating expenses, 57%.[5] That survey also indicated that the cost of funds for instalment loans was 60%

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[4] These data are from The Nilson Report, as referenced in the Federal Reserve Bulletin, September 1992.

[5] Federal Reserve Banks, "Functional Cost Analysis: 1991 National Average Report."

of total costs; for real estate mortgage loans, 79%; for commercial and other loans, 68%; and that credit losses for these three types of loans ranged from 4% to 9% of total costs.

Thus, cost of funds is a much smaller proportion of total cost., and credit losses a much higher percentage, for credit cards than for other types of loans. There have also been significant increases in credit card losses in recent years.

From a profitability standpoint, net earnings before taxes for the Visa and MasterCard issuers in 1991 was 3.4% of outstanding balances and 2.6% of outstanding balances for the small- and medium-size banks. These net earnings ratios have fallen in recent years although they are still much higher than those on total bank assets. In light of the rate cuts by major credit card issuers within the past year and the increasing credit losses, together with the entry of nonbank entities into the credit card market, it is very likely that the profitability of banks' credit card operations will decline further in 1992 and 1993.[6]

Policy Implications

In considering whether to reimpose rate ceilings, it is essential to examine past experience with such ceilings and the implications of doing so. A study by the Banking Department in 1976 on mortgage lending concluded that interest rate ceilings limit the availability of credit, cause banks to impose more

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[6] Citicorp recently projected that revenues from credit cards would fall by $150 million in 1993 because of lower card rates.

stringent credit standards and result in more restrictive terms.[7] Studies dealing with the experience of other states confirmed the adverse effects of usury ceilings.[8]

Reimposing rate ceilings on credit cards or other types of consumer loans can be expected to lead to similar results. Those persons who are not deemed the best risks will find that they are either unable to obtain credit or will have their borrowing limits cut back. This, in turn, could have serious effects on retail stores throughout the State who depend upon credit card users for much of their sales. Ceilings on credit card interest rates could also lead issuers to reduce or eliminate grace periods, require higher minimum monthly payments, raise various fees and could have serious effects on the market for credit card receivables.

Moreover, rate ceilings on credit card loans in New York State could adversely affect employment in the State while providing no rate protection for New York cardholders. As a result of the United States Supreme Court decision in the _Marquette_ case[9] and

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[7] _The Impact of New York's Usury Ceiling on Local Mortgage Lending Activity_, Ernest Kohn, Carmen J. Carlo and Bernard Kaye, New York State Banking Department, January 1976.

[8] Arthur Rolnick, Stanley Graham and David Dahl, "Minnesota's Usury Law: An Evaluation", Federal Reserve Bank of Minneapolis, _Ninth District Quarterly_, April 1975; Norman Bowsher, "Usury Laws: Harmful When Effective", Federal Reserve Bank of St. Louis, _Review, August 1974_; Philip Robins, "The Effects of State Usury Ceilings on Single Family Homebuilding", _Journal of Finance_, March 1974; Maurice Goudzwaard, "Price Ceilings and Credit Rationing", _Journal of Finance_, March 1968.

[9] _Marquette National Bank v. First of Omaha Service Corp._, 439 U.S. 299 (1978).

passage by Congress in 1980 of the Depository Institutions Deregulation and Monetary Control Act, national and state-chartered banks are allowed to charge whatever rates are permissible in the states where their credit card operations are domiciled. In addition, the 1992 fe eral Circuit Court decision in the Greenwood Trust Company case and two other District Court decisions held that banks may also charge customers in other states whatever late payment and overlimit fees are permissible in the states where their credit card operations are located.[10]

Thus, New Yorkers would not be protected by interest rate ceilings or fee limitations imposed by the New York Legislature if credit cards are issued from outside of New York State to New York residents. A number of large card-issuing banks, including three of the four largest card-issuing banks in New York (Citibank, Chase Manhattan and Bank of New York), have already moved their credit card operations out-of-state. Since 1980, thousands of jobs have been gained by South Dakota, Delaware, Maryland and Nevada as employment, income and tax revenue have been lost to New York.

A reimposition of rate ceilings would create a strong incentive for other banks to move their credit card operations out-of-state. At present, more than 3,000 persons are employed in credit card operations within New York State by Chemical Bank, Marine Midland Bank, National Westminster USA, Key Bank, Fleet Bank

[10] Greenwood Trust Company v. Commonwealth of Massachusetts, 971 F.2d 818 (1st Cir. 1992); Hill et al. v. Chemical Bank, 1992 Westlaw 185137 (D. Minn.); Nelson et al. v. Citibank (Delaware) N.A., 794 F. Supp. 312 (D.Minn. 1992).

and others. The economic importance of these jobs is magnified by the "multiplier" effect of the income they provide which is spent, thereby creating additional jobs and income in New York.

To summarize, from the standpoint of consumers, deregulation has broadened the availability of credit, increased maximum credit lines and resulted in a wider range of consumer loan products being offered. Retail stores which depend heavily on credit card sales have benefited. As a result of their earnings on consumer loans, banks have been able to improve profitability and thereby help rebuild their capital strength so that from a "safety and soundness" standpoint, deregulation has had a beneficial influence. Finally, the reimposition of ceilings on credit card interest rates would lead to a further exporting of jobs to other states while providing no rate protection for New York cardholders.

Taking all of these factors into consideration, the reimposition of rate ceilings is unnecessary and would be counterproductive. The best way to protect the interests of consumers and workers in New York State is by providing information on the basis of which they can make informed choices on credit. The Banking Department has for many years disseminated information on rates and terms of many types of consumer loans, including credit cards, in its periodic publication "Consumer Guide to Bank Services". These Guides are sent to all State legislators for distribution to their constituents, to hundreds of libraries all over New York State and to the New York City Borough Presidents' offices for distribution to local Community Boards. The

dissemination of this information enables consumers to engage in comparison shopping for credit which helps make competition more effective.

Consumer information is also mandated by New York State and federal law and regulations which requ: : disclosure of rates, fees and other terms of consumer loans prior to any transactions made by the customer. Moreover, in the event of any solicitation of or application for credit cards or charge cards, federal law and Regulation Z, which preempt state law, require disclosure of rates, fees and other terms for such cards.

ORAL TESTIMONY OF NANCY S. DONOVAN

BEFORE THE SUBCOMMITTE ON CONSUMER CREDIT AND INSURANCE

ON BEHALF OF

THE AMERICAN FINANCIAL SERVICES ASSOCIATION

MARCH 22, 1994

Mr. Chairman, members of the Subcommittee, my name is Nancy Donovan and I am President of NOVUS Financial, A Dean Witter Company, located in Riverwoods, Illinois. I am presenting this testimony on behalf of the American Financial Services Association (AFSA)in my capacity as Chairman of the Board.

AFSA greatly appreciates the opportunity to present its views concerning H.R. 3153, "The Home Equity Protection Act". H.R. 3153 raises important economic and policy issues and we hope that our testimony assists you in balancing the merits on each side.

Let me begin by commending your willingness to make changes to this legislation. The modifications you have already proposed appear to address many industry concerns. I am confident that a bill can be crafted that will protect consumer credit availability. We look forward to working with you on this legislation.

The purpose of the bill, as we understand it, is to remedy unjustified foreclosures of second mortgages resulting from abusive lending practices. As described in hearings held in this Subcommittee, and in the Senate, abuses occurred where vulnerable consumers with significant equity in their homes were targeted by home improvement contractors and other third parties.

These practices harm not just consumers, but legitimate, mainstream lenders. AFSA members have a strong interest in the elimination of such abuses. We want to assist you in doing so.

Mr. Chairman, let me also mention that my company makes <u>no</u> loans that would be affected by this bill. This is true of many other AFSA member companies. Yet we are concerned about the approach the bill takes, because we think it could inadvertently curtail some legitimate loans that consumers need to improve their homes, finance educational expenses or for a host of other purposes. Even with the enactment of this legislation, abusive

lenders could avoid regulation. The principal problem is with the bill's definition of "high cost mortgages."

The definition focuses on two components of a second mortgage: interest and points in excess of a stated ceiling. A loan which meets either one of those triggers cannot also have certain loan terms (such as a balloon payment feature,, and cannot be transferred unless the assignee remains liable under the loan. While, technically, this does not forbid the making of such loans, its practical effect is to prohibit them, because the forbidden terms are often essential ones if the loan is to be economically viable or if the lender is to be able to securitize it. Put another way, a loan that is not permitted to contain these terms is a loan that may not be made.

Our concern is simply this: a loan cannot be said to be too costly merely because it contains a single feature that appears to be high. In some cases such a loan may be suitable and affordable for a particular customer, and represent default or foreclosure risk though it contained one or more of the loan terms that would be prohibited under the proposed definition.

Regulating -- or prohibiting -- loans that contain unacceptable interest rates or points <u>will not deter abusive lenders.</u> Such parties can avoid coverage by simply pricing their loans below the "trigger" rates. They would escape regulation as "high cost" lenders, but could continue to prey on consumers by making loans that are unsuitable or unaffordable for a particular customer, or that contain terms that, in combination, are unfavorable. And they could continue to use abusive collection and foreclosure tactics.

The terms that could not be included in "high cost mortgages" are important components in the pricing of many loans and may be beneficial for consumers. For instance, a balloon payment feature may make the loan more affordable, because periodic payments will be lower Balloon payments may also be found in short term, higher rate, "bridge loans" that buyers need when they close on a new house before they sell their old one.

The market must continue to be able to meet customer needs by devising many and varied products that carry a wide range of features and prices. While we know it is not the intent of the bill to deter legitimate lending, it is very difficult to, if not impossible to avoid such a result when directly or indirectly regulating the price of loan products. This conclusion was convincingly described in a recent study by the New York State Banking Commission (attached to our written statement). It found that where rates are deregulated, the availability and variety of credit products increase significantly with major benefits to the consumer. The New York legislature, based on the study, and the

behest of Governor Cuomo, earlier this year enacted legislation which substantially deregulated interest rates.

Mr. Chairman, mortgage lending abuses cannot be addressed by focusing on isolated loan terms or by trying to restrict loans that someone thinks are too costly. Addressing abuses will be unsuccessful without taking into account all of the elements that might provide an opportunity for consumer exploitation. Such factors as the consumer's understanding of the costs and the consequences of nonpayment, the ability of the consumer to afford loan payments when added to other obligations, and the lender's collection and foreclosure practices, must also be considered. We urge the Subcommittee to consider the alternative recommendations that are made in our written statement.

Finally, as the Subcommittee explores ways to address mortgage lending abuses, we urge a careful consideration of the impact of the application of the Real Estate Settlement Procedures Act (RESPA). RESPA was applied to second mortgages for the first time at the end of last Congress, and its implementing rules will take effect in August.

RESPA will eliminate most of the abuses that concern the Subcommittee. Indeed, in issuing its regulation, HUD stated that it targeted abuses disclosed in Congressional hearings. For example, RESPA will address the profit motive of abusive lending loans by requiring disclosure of fees and by prohibiting unearned fees and prohibiting unearned fees and kickbacks. RESPA's good faith settlement cost estimates provided at the time the loan is applied for will allow consumers to appreciate the true cost of a loan before they sign on the dotted line. We believe that any legislation should take the impact of these new requirements into account.

AFSA appreciates the opportunity to present its views and hopes that our testimony assists the Subcommittee in its deliberations.

TESTIMONY BEFORE THE U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
GIVEN BY TERRY DRENT, EXECUTIVE DIRECTOR,
WASHTENAW COUNTY COUNCIL ON AGING
MARCH 22, 1994

PROBLEM

Many people living on fixed incomes in Michigan and the rest of the country are facing a crisis. For many the cost of medical care housing, and basic sustenance is so high that they have to supplement their incomes with debt in order to survive. In Southeastern Michigan we are seeing many low income families, senior citizens, and disabled people who live on fixed incomes being preyed upon by unscrupulous mortgage companies with a practice known as reverse red-lining. These firms often target lower income families claiming to be able to assist them in paying for medical care, home repairs, and property taxes. The results, however, can lead to the misery and impoverishment of this population Many of these homeowners are suffering great hardships because of the financial "solution" offered by mortgage companies. Some people are actually being forced out of their homes.

BACKGROUND

People living on fixed incomes are susceptible to abuse by mortgage companies because they have seen their expenses for vital items increase at a rate greater than their incomes Social security has increased at an average rate of 3.5% a year over the last four years. Medical costs have increased by 15% to 20% in the same period. Senior citizens alone account for 40% of all hospital stays and have many needs not met by any insurance company including expensive special diets, devices to assist in mobility and many necessary health items.

When these fixed income individuals are homeowners, the burden is greater because of the need to make repairs on their home If a roof is leaking or a furnace breaks it has to be fixed Additional repairs or remodeling must be completed to accommodate a sick spouse or physical limitations of the homeowner. Increasing health problems can create home accessibility needs. Lowering bathroom fixtures and cupboards and building ramps and railing is a very expensive undertaking, though less so than hospitalization. An additional problem is the increase in property taxes over the last several years as localities and school districts continue to face budget imbalances, some due to cuts in Federal funds.

Lower income families have less and less disposable income and are being forced to make difficult choices. They must often choose between paying their medical bills or buying food, paying for a special need for themselves or an ailing spouse or paying for a necessary home repair paying for home repairs or paying their property taxes. Like most of us they choose to pay for their most immediate basic need and many important bills, including their property taxes, are unpaid.

EXAMPLES

I would like to share with you some examples of Michigan residents who have suffered financial burdens, stress, and in some cases, the loss of their homes, to companies involved in these practices.

In Whitmore Lake, Michigan, we have a case of a 77-year-old widow who could not pay her medical bills and her property taxes. A mortgage company got her name from the delinquent tax role published by the County Treasurer's Office. In 1989 this woman received a $12,729.50 mortgage at over 25% interest. Her monthly mortgage payment without property taxes was $350 per month, while her monthly income was $520 , derived solely from social security. The loan had a three year balloon payment. At the end of the term she was unable to pay the balance due on the loan and the mortgage company refinanced the loan with similar terms and the woman defaulted. The mortgage company wrote her a loan for the third time Her debt increased from the original $12 729.50 to $39 500 within eighteen months. This woman actually received only $4,066 from these two additional transactions, the rest going to pay points and administrative fees The equity was sucked out of her home and she was propelled into a maelstrom of abject penury

This senior citizen could not read the mortgage documents she apparently signed because of partial blindness and she did not understand the mortgage process as she suffers from Alzheimer s disease and has a third grade education She had neither a checking nor a savings account, though she did once own her own home free and clear. In a court agreement negotiated with the mortgage company, the woman had eight months to refinance her total debt so she would not lose her home of over forty years. However, she lost her home last summer.

In Romeo, Michigan, I worked with a 65 year old woman who discovered water streaming into her basement. She was worried about this condition and called a building contractor to inspect her home. The contractor arrived accompanied by a mortgage broker. They told the woman that if she did not immediately sign documents she was told were to authorize repairs that her home of 35 years would literally fall down The documents she signed were actually mortgage forms, and when she attempted to rescind the documents, she was told that the three day right of rescission had elapsed.

Her new mortgage was for $25,000 at 19% interest and she paid 14% of the loan amount for processing fees and discount points. Her only source of income is her monthly social security check of $900 per month.

In Ann Arbor, Michigan, court documents reveal that an elderly woman was solicited for home repairs by a representative of a construction company who came to her front door. This woman was presented with numerous documents authorizing the needed repairs, all of which she signed. And she was given copies of all of these papers except one which was a mortgage form. The witness on the loan, a vice president of the building company, was not present at the signing of the mortgage. The building company representative stated in a deposition that she checked the box on the mortgage form creating a security interest in the woman s home and witnessed the document so the loan could be sold to a bank adding that this is the practice of her company as the bank likes "the I's dotted and the T's crossed." It would seem that the bank, Comerica Bank, is also a victim in this

transaction, however, they had an indemnification agreement with the building company to insure them against any loses due the builders actions. Without assignee liability this type of loan will continue to be common practice for many businesses.

One of the more insidious methods used by some mortgage companies to obtain clients starts with tax purchasers, or tax lien buyers. Purchasing taxes is a big business and many companies, including banks and mortgage companies, as well as individuals are involved. The tax lien buyer will purchase the taxes and get a lien on an individual's home. Next, they contact the homeowner and inform them that unless the purchased taxes are paid in full, the home will be foreclosed upon. The tax buyer then offers a deal--if the homeowner is unable to pay the full amount, the company will arrange a monthly payment plan that will allow the homeowner to stay in their home Because the homeowner is desperate to remain in their home, the deal is agreed upon. The tax purchaser then refers the homeowner to a mortgage company, which the tax purchaser actually owns. The mortgage company will exchange the tax lien for a mortgage. Again, the mortgage offered is generally double the market rate with very high administration and processing fees. The homeowner gets a mortgage they cannot afford to pay and over time the mortgage company forecloses.

In Ypsilanti, Michigan, a 40-year old mentally disabled man owned a home his mother left him "so he would always have a place to live". But his property taxes increased more than the disability income he received from the state, and he became delinquent in his property taxes A property tax purchasing company, Alpha & Company, owned by the Foote family of East Lansing, Michigan, bought his taxes and exchanged the tax lien for a mortgage through a finance company also owned by the Foote's named First National Acceptance Corporation. The homeowner was paying 15% under the tax lien, but his new mortgage with First National Acceptance Corporation had an interest rate exceeding 21%. His mortgage payment was $250 a month before property taxes while his monthly income was only $220.

Alpha & Company, First National Acceptance Corporation, and the First National Bank of Michigan are all owned by the Foote family, and this multi faceted empire feeds off the spoils created by tax sales and high cost loans A leading financial analysts reports that First National Bank of Michigan is one of the most profitable banks in the country. But this synergy is not unique to the Foote family or Michigan. Many banks across the country report huge investments in tax liens and speak of the fantastic returns on their high cost loans to cash strapped citizens who will enter into any almost any loan, regardless of the terms or disclosures, to save their homes.

Recently First Boston Corporation, which is owned by Credit Suisse, developed a strategy to purchase all delinquent tax liens for entire cities and counties. In effect, we have foreign bankers collecting taxes on behalf of American government by either foreclosing on the homes of our citizens or taking advantage of their desperation and economic vulnerability with high cost loans. This is an unacceptable situation.

There are many abuses in the non-conforming mortgage market, and what were once considered usurious mortgages are now allowable under current law. Many lower income homeowners are being victimized. We are not against non-conforming mortgages, as many serve a legitimate purpose. However, we feel that there are consumer protections that can be put in place to help protect the low income, vulnerable, and disadvantaged from an unchecked and under-regulated segment of the banking industry. We recommend the following for your consideration.

RECOMMENDATIONS

* Define a class of mortgages as high cost loans

* Repeal exemptions from state usury laws in the Federal Banking Statute.

* Strengthen and clarify the notice of foreclosure prevention services existing in current law.

* Require judicial foreclosure of high cost loans.

* Amend Older American's Act to require that low income senior citizens be referred to social service agencies before their property can be foreclosed.

* Develop assignee liability for purchasers of high cost loans.

SUMMARY

The problems associated with reverse red-lining mortgages are severe. States and local governments do not have the resources to grapple effectively with these lending problems, and many people are falling through the gaping holes in the small safety net that society provides. Federal legislative action is needed to help solve the problems associated with high cost loans and an abusive mortgage system. The practice of reverse red-lining mortgages is threatening the sanctity of part of the American Dream, home ownership, for those who can least afford it. This activity is wrong, unfair, and unjust; it must be stopped.

Statement of Frederick H. Reeves
before
The House Banking Subcommittee on Consumer Credit and Insurance
March 24, 1994

This statement is made on behalf of Calcasieu Financial Services Corp., Located in Lake Charles, Louisiana. Our company was founded in 1953 by Edward H. Taussig, a prominent Lake Charles businessman, who used the company as a financial outlet for the numerous automobile dealerships that he owned. After the dealerships were sold in 1966, the company was bought out by his son, James E. Taussig, and myself, Frederick H. Reeves, who are present owners in a fifty-fifty partnership.

Since the sale of the dealership we have progressively moved from auto financing to a more well rounded portfolio of consumer loans. Our outstandings include about 100 small real estate loans which we have been making for the last twenty-eight years. As of this date, we have not foreclosed on one single home.

This short history is only to explain that we have performed a vital service to our community for over 40 years. We feel that passage of H.R. 1415 will greatly hinder our ability to make small real estate loans to customers who fall through the cracks of traditional real estate lending.

The folks that we loan to often have credit problems and do not meet the qualifications of standard mortgage companies or banks. We provide our service at a reasonable cost because we do not have high closing costs including appraisal fees, updated abstracts and attorney fees. The small loans that we make simply can not afford these added charges.

Our concern is that because of the additional disclosures and elimination of rebating prepaid loans by the rule of 78's, it will be almost impossible for us to continue making these small real estate loans. It appears that the disclosure section of the bill has been addressed by Truth in Lending as well as the RESPA Act of 1992. It seems that we have enough papers to give the customer now and additional disclosures will only confuse more than it will clarify the transaction to our customers. Rebating by the Rule of 78's has been a standard for many years and allows us a little extra cost recovery in the early months of a loan. This is necessary when dealing with the size loans that we make in our office.

Our recommendation would be to eliminate loans of sixty months or less maturity that do not have a balloon type feature from the bill. When a company is extending credit on loans of sixty months or less, the additional paper work costs and elimination of the Rule of 78's will make it nearly impossible to service the very people who need our services most.

TESTIMONY OF ROGER J. O'CONNELL
PRESIDENT, LORNTY INVESTMENT COMPANY
SEATTLE, WASHINGTON

SUBCOMMITTEE ON CONSUMER CREDIT AND INSURANCE
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

MARCH 22, 1994

TESTIMONY OF ROGER J. O'CONNELL

My name is Roger J. O'Connell. I have had more than 25 years of experience in real estate lending. I spent more than 20 years in income property lending, that is construction loans and permenent loans on apartment buildings, office buildings, and shopping centers. I have served as president of a mortgage banking company and have been in charge of income property lending for a national bank.

In 1990, I took a sabbatical from tha banking industry fully intending to return. However, I had the opportunity to think about the radical changes that were affecting tha banking industry; in particular, all the new regulatory restrictions on real estate loans. I recognizad that there were far fewer real estate lenders than there had been at any time during my career and that there were many borrowers who simply could not meet the rigid underwriting guidelines applied by banks to real estate loans. More than at any previous time in my experience, the very reason borrowers needed credit disqualified them from obtaining it.

To take advantage of this market opportunity Lornty Investment Company was formed in 1991 by me and my partners, Bennett Williams and Sue Williams to make real estate loans to consumers and businesses. It was formed to fill the gap created by the withdrawel or the significant curtailment of assat-based real estate lending by banks, credit companies, insurance companies and other traditional lenders for regulatory, risk, and asset allocation reasons.

Lornty's primery lending philosophy is that the borrowers have large equities in their real estate, have a plan for repayment, and have the capability of implementing that plan.

This philosophy has workad. We have raised about $15,000,000 from private investors and have closed over 200 loans. We have a $15,000,000 loan portfolio. We have an average delinquency of 2.5% and have had only three foreclosures in three years. Of the 200 loans, 118 (58%) were to consumers, all with poor to average cradit. In two of the three foreclosures we received letters from the borrowers apologizing for the foreclosure and thanking us for our help and the way we handled the problem.

A typical profile of a Lornty loan is a consumer between 35-50 years of age, borrowing $120,000 to either pay off the IRS, pay off cradit cards to lower their interest rates, or to pey off another lender who is foreclosing. The loans are interest only, have a balloon payment within one to two years, an interest rata between 14-16% and a loan fee of 2-4%. *Why would anyone pay*

those rates and fees? The reasons are that traditional financial institutions do not make these types of riskier loans and our quick response; i.e., from the date the borrower calls to the date of closing is 5-7 days.

Of the 118 consumer loans, over half were made to borrowers who were in the foreclosure process and would have lost their homes if Lornty had not given them a loan. All but two of these loans have been paid off or are now in good standing.

<u>Why Is There A Market For High Interest Consumer Loans?</u>

1. Consumers get divorced, family members fight over inheritances.

2. Consumers lose their jobs because of industry changes.

3. Not all consumers have perfect or near-perfect credit, often because of circumstances outside their control such as poor health, doctor bills, loss of job, etc.

4. Not all consumers file their tax returns in a timely manner.

5. Not all consumers succeed in their own business.

6. Very often family members want to help each other when one of them is having a financial problem.

7. Not all consumers save enough for their children's private school or college educations.

8. Sometimes consumers do not have enough capital to buy or complete their dream home.

9. Sometimes consumers buy a new house thinking their first house will sell right away, then run short of money to pay two mortgages. Some of these situations put a consumer in a foreclosure situation.

10. Some consumers have substantial equity in a non-owner occupied rental and want to pull out some of that equity for personal use. Banks would not make this loan even with perfect credit.

11. Some consumers have been bankrupt.

Why Don't Banks Help?

Generally speaking, the banks are not in the helping business.

Most "bank" real estate loans are sold on WALL STREET. To qualify for bank loans, numerous forms need to be filled out, boxes checked, ratios met, and the consumer must be regularly employed and no more than 1/3 of the consumer's income can be required for the payments on the loan.

Neither the banks nor WALL STREET want to listen to the reasons a consumer needs a loan. If the consumer fits the boxes, a loan is made. If not, the loan will be turned down.

In each of these situations, high interest lenders such as Lornty Investment Company provide capital for bridge loans (short term) to help solve the problem, if the borrower has sufficient collateral and an acceptable plan to pay off the loan. This fills a void in the market place.

Examples

I want to give you some real examples of loans provided by Lornty to solve real problems. These loans are typical of the kind of loans provided by honest, legitimate high interest lenders like Lornty.

1. Mr. and Mrs. XYZ are good business people. They entered into an exchange and wound up with their dream home. As part of their exchange they assumed a note and owed the prior owner the balance of their contract ($50,000) in a balloon payment.

In the meantime, the IRS claimed that Mr. and Mrs. XYZ owed $70,000 in back taxes and filed a lien against their home. No bank would lend them the required capital to pay off the first mortgage and the IRS. LORNTY INVESTMENT COMPANY did and paid off the IRS.

2. Ms. G was widowed at age 30. She and her deceased husband had acquired a house. Life insurance proceeds paid it off.

Ms. G was emotionally incapable of living in the house and for the past two years had rented it to students. Ms. G, who was employed, decided that she wanted to go back to school to get her degree, and to pay-off her car and credit cards.

She was about to be an unemployed minority student! Her security was a non-owner occupied rental. No bank would make the loan. LORNTY INVESTMENT COMPANY did, and provided a full interest reserve so that Ms. G didn't make the payments for 18 months. The plan worked. Ms. G finished school, got a very good job, then the bank did make the loan and paid off LORNTY.

3. Mr. G is an attorney whose son was killed in an automobile accident. For a period of one and a half years he couldn't cope and practiced little law. His credit suffered and his house was being foreclosed.

The bank did not want to touch this loan. LORNTY INVESTMENT COMPANY helped get Mr. G back on his feet. Our loan staved off the foreclosure and paid off credit card bills. His home was saved. Today Mr. G is again practicing law on a full-time basis. His credit problems are behind him.

4. Mrs. T's father had suffered for a long period of time and eventually died of cancer. He lived in Georgia.

Mrs. T, who had always been a good saver, used all of her savings to help with her father's medical bills and to pay for travel back and forth from Seattle to Atlanta.

Mrs. T fell behind in her house payments and the lender would not consider her payment plan (servicing had been sold). The lender began a foreclosure.

Mrs. T is a minority and lived in a neighborhood not normally looked on with favor by banks. She couldn't get a bank loan. LORNTY INVESTMENT COMPANY helped stave off foreclosure and pay back medical bills for her father.

After one and a half years Mrs. T obtained a conventional loan and repaid LORNTY INVESTMENT COMPANY in full.

<u>None of these loans could have been made if HR 3153 was law</u>. The loans we made to borrowers who were in foreclosure could not have been made. In all likelihood those borrowers would have lost their homes.

I am including with this testimony, letters from some of our borrowers giving testimonials about the need for the credit we provide and which HR 3153 would eliminate.

The experience of our company is not unique. In Washington, CLS Mortgage in Spokane has a $20,000,000 portfolio of higher interest loans and had only two foreclosures last year. Investors Mortgage in Seattle has similar experience. Like Lornty, those lenders are HUD approved mortgagees.

Analysis of HR 3153

HR 3153 proposes to amend the Truth In Lending Act by requiring special disclosures for and by imposing restrictions on so-called "high cost mortgages."

If enacted, HR 3153 will eliminate so-called "high cost mortgages" from the market, ostensibly in order to protect consumers' equity in their principal residences. The proposed legislation, if enacted, will be a classic illustration of the law of unintended consequences. Instead of protecting homeowner's equity, it will result in the loss of homes through foreclosure because there will not be credit for consumers who do not meet bank underwriting guidelines.

What is a "High Cost Mortgage"?

The proposed amendment defines a "high cost mortgage" as any loan secured by the consumer's home if the "finance charge" (which includes the interest rate on the loan and the loan fees and other charges) exceeds the one year treasury bill rate by more than 10%. Currently, this means that a loan with an interest rate of 11% and loan fees and charges of 2% would be a "high cost mortgage." This is considerably less than the interest typically charged consumers on credit cards which would not be affected by this legislation.

Who Are the Customers for "High Cost Mortgages"?

As a general rule, the customers for these so-called "high cost mortgages" are people who do not qualify for traditional bank financing for a variety of reasons. They may be between jobs. They may be starting a new business and have no assured source of income. They may have unpaid income taxes. They may have recently filed bankruptcy or have suffered other credit problems. In none of those instances would they qualify for credit from traditional banking sources. There are also consumers who simply cannot afford to wait for the cumbersome procedures required by most traditional lenders.

The need for non-bank credit has increased dramatically in the last few years because of strict appraisal requirements and other underwriting restrictions imposed on banks. A typical customer for a "high cost mortgage" is someone who needs credit in order to stave-off a pending foreclosure, to pay income taxes or to provide a breathing space for the sale of assets. Often, the very reason they need the credit disqualifies them for traditional bank financing.

Under the proposed legislation, any consumer who could not qualify for real estate financing from traditional banking sources would be unable to obtain financing. This will inevitably increase the incidence of foreclosures.

What is the Purpose of the Truth in Lending Act?

The historic purpose of the Truth In Lending Act was to ensure the informed use of credit by consumers (15 U.S.C. § 1601(a)). The Truth In Lending Act attempts to accomplish that purpose by requiring a creditor to clearly disclose the cost of the credit and then relying on market competitive forces to hold down the cost of credit. HR 3153 departs from this historic purpose by attempting to prohibit so-called "high cost mortgages" rather than simply requiring disclosure of their cost.

What are the Specifics?

The proposed legislation:

1. Requires the creditor to refund loan fees if the loan is accelerated because of the consumer's default, thus giving the consumer a financial incentive to default (§ 129(c)).

2. Prohibits charging an interest rate on default which is greater than the stated interest rate on the loan, thus removing a financial disincentive to default (§ 129(c)).

3. Prohibits payment of interest on the loan out of proceeds of the loan (§ 129(f)), thus ensuring that any consumer who does not have current monthly income sufficient to make the monthly payments will not be able to obtain credit.

4. Prohibits any home equity loan if there is not a probability that the consumer will be able to make the payments (§ 129(g)(1)), thus prohibiting the extension of credit to those who need time to sell assets or find a new job.

5. Requires the creditor to demonstrate that the consumer understands all the disclosures (§ 129(g)(2)), thus ensuring that honest and competent creditors will not take the risk of extending

credit to any but the most sophisticated borrowers, who often do not need credit from non-traditional sources anyway.

6. Prohibits paying off a consumer's existing loan which is not then in default out of the proceeds of a new loan unless the new loan is at a lower interest rate (§ 129(g)(3)), thus requiring a consumer to suffer the consequences of default before arranging financing.

7. Eliminates the federal preemption of state usury restrictions for qualified lenders (such as HUD approved mortgagees) who make loans securad by a first lien on residential real estate (Section 3).

8. Prohibits balloon payments (§ 129(d)), thus requiring every creditor to extend long-term credit and as a consequence driving up interest rates (which are lower on short-term financing) and increasing the monthly payments by requiring amortizing payments of principal and interest.

What Will Be the Effect of These Requirements?

HR 3153 is a well intentioned attempt to restrict the operation of free-market forces. However, rather than reducing the risk of loss of homes through foreclosure it will significantly increase the risk by eliminating a source of credit for consumers who cannot qualify under ever stricter bank underwriting guidelines for real estate loans. Often, non-traditional financing sources offer the only way for a consumer to avoid bankruptcy or foreclosure. The kind of loans made by Lornty and other honest, legitimate, high interest lenders cannot be made if HR 3153 becomes law.

For example, many of our loans are made to consumers who do not have a source of income to make monthly payments on the loan. Often the very reason they need the loan is to give them time to sell assets or to get a job. HR 3153, by prohibiting balloon payments and payment of interest out of loan proceeds, would prohibit all but fully amortizing loans. If the borrower does not have a source of monthly income sufficient to make the payments, he/she will not be able to get the loan, and thus, will lose his/her home through foreclosure.

The proposed legislation will dramatically reduce the amount of non-traditional credit and thus increase the incidence of foreclosure and bankruptcies.

<u>What Are Some Alternatives</u>?

The impetus for this legislation is the disastrous experience of some consumers who were duped into accepting home improvemant loans from door-to-door solicitors who then sold the loans to institutional investors. Because the loans were sold to a "holder in due course," the consumers could not use the misrepresentations of the door-to-door solicitors as a defense to foreclosure. Unquestionably there are numerous other examples of unscrupulous lenders who use the law to take advantage of unsophisticated consumers.

The problem with HR 3153 is that in an attempt to prevent these unscrupulous practices, it also eliminates financing offered by honest lenders to needy consumers who understand exactly what they are contracting for.

We suggest that a better approach would be to attempt to eliminate these unscrupulous lenders from the market. One way to do this would be to exempt "HUD-approved mortgagees" from the effect of the proposed law. None of the lenders identified in the testimony before the Senate Subcommittee or this Subcommittee were HUD approved mortgagees.

Under present federal law, mortgage lenders who meet certain financial, organizational and ethical standards may be approved by the Secretary of the Department of Housing and Urban Development for participation in mortgage insurance programs offered under the National Housing Act (12 U.S.C. § 1701). Those mortgage lenders are referred to in the industry as "HUD-approved mortgagees." To be a HUD-approved mortgagee, a mortgage lender must: (1) be a corporation or other permanent organization, with a net worth of at least $250,000; (2) maintain adequate staff and facilities to originate and service mortgages in accordance with applicable federal regulations; (3) comply with provisions of the Fair Housing Act, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act, and all other federal laws that relate to the lending or investing of funds in real estate mortgages; (4) certify annually that they have not been refused a license by any state; (5) submit annual audited financial statements upon request by HUD; (6) implement written quality control plans that assure HUD of compliance with HUD regulations and requirements regarding mortgage origination and servicing; (7) maintain liquid assets at least equal to 20 percent of their net worth; (8) file annual verification reports with HUD; and (9) obtain fidelity bond coverage and errors and omissions insurance coverage acceptable to HUD.

No mortgage lender is eligible to be a HUD-approved mortgagee if any of their officers, directors, principals or responsible employees have been suspended, debarred or otherwise restricted under HUD regulations, indicted for or convicted of any offense involving moral turpitude, or have engaged in

unethical or unsound business practices. The Mortgagee Review Board established under Section 202(c)(1) of the National Housing Act was spacifically created to handle administrative actions against HUD approved mortgagees and HUD actively polices and prosecutes HUD approved mortgagees who engage in dishonest or unethical practices.[1]

These qualifications and regulatory supervision are sufficient to assure that, in almost all instances, a HUD-approved mortgagee will not be engaged in the kind of fraudulent and unscrupulous practices HR 3153 is intended to prevent. In addition, the elimination of "holder in due course" status for any assignee of a high cost mortgage will effectively avoid the possibility of any defrauded consumer being unable to raise the fraud as a defense to foreclosure of the mortgage. Elimination of holder in due course status for this kind of consumer debt is similar to that already in effect under the FTC Rule "Preservation of Consumers' Claims and Defenses," 16 CFR 433.1-433.2.

We would suggest, therefore, that HR 3153 be amended to exempt HUD-approved mortgagees from all provisions of HR 3153 other than the elimination of "holder in due course" status for any assignee of a high cost mortgage.

Conclusion

Recently the Washington State Legislature enacted the Consumer Loan Act, which permits interest rates up to 25% for lenders who secure a license under the provisions of RCW Chapter 31.04. The Consumer Loan Act includes a specific finding by the legislature as follows:

> "The legislature finds that borrowers who represent a higher-than-average credit risk are unable to obtain credit except at interest rates higher than permitted under other statutory provisions governing interest rates for loans. Therefore, it is the purpose of this chapter to authorize higher interest rates for certain types of loans subject to the conditions and limitations contained in this chapter in order to ensure credit availability." (RCW Section 31.04.005.)

That finding embodies the lesson that restricting interest rates and types of credit simply takes credit away from those who need it most. The proposed

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[1]See Semiannual report to the Congress, for the period ending September 30, 1993, U.S. Department of Housing and Urban Development, Office of the Inspector General.

legislation should be carefully designed to eliminate abuses, but not to eliminate credit for those who need it most.

[illegible] S.W. TACOMA, [illegible]

WILLIAM M. RILEY

January 21, 1994

Mr. Roger O'Connell
President, Lorraty Investment Co.
214 Fifth Avenue S.
Seattle, Washington 98104

Dear Roger:

I am writing to add a voice in opposition to U. S. Senate Resolution # 1275 and U.S. House of Representatives Resolution # 3153.

I oppose both, because they would remove a source of lending that is now helpful to many citizens and crucial to others.

Given the existing Federal laws, it is extremely difficult, expensive and time consuming to borrow money.

A source of loans that is quick and efficient is very attractive, even though it may be available only at higher than normal interest rates and fees.

I want to point out that the "higher than normal" rates and fees are not necessarily high.

If rates and fees are calculated only on new money, the actual dollar cost can be dramatically lower than traditional costs of borrowing.

If no appraisal is required, the timing and costs of borrowing are further minimized.

I hope that your efforts in Washington, D.C. are successful!

Sincerely,

William M. Riley

DONALD T. LEABO
19008 NE 198TH
WOODINVILLE, WA 98072

January 20, 1994

To Whom It May Concern,

This letter is to state my views on high cost mortgages and the effect and benefit they provide.

As a recent user of high cost mortgages, I have first hand knowledge of their effect and how they work. In the past five years, I left a national manufacturing firm as a sales representative to start my own business with two other partners. Immediately upon resignation from this national firm, a major lawsuit was filed against me and my partners. This lawsuit tied up and directed a large amount of capital towards attorneys, etc. Since I had several real estate holdings, I was forced to file a Chapter 11 Bankruptcy so I could have enough time to sell them without loosing them through foreclosure. The profits went back into the company in an effort to move forward. I was, however, faced with my own personal home refinance which had a balloon payment, which meant a cashout or refinance.

I approach Lomty Investment Company, a high cost mortgage lender, for help in refinance. They put the transaction together and made the loan. This meant paying off all my Chapter 11 debts and allowing me to escalate myself out of bankruptcy. This gave me a new start with one major debt, that being the loan from Lomty Investment.

As it turned out, the company's growth was slow. In the interim, I found out that one of my partners had embezzled almost $500,000 in cash and I left the company. I have not been able to recoup any losses. Because of this fraud, I was left with starting all over again. This meant not being able to pay off the Lomty Investment loan and I eventually lost the house.

It is absolutely imperative that high cost mortgage loans be available to situation like mine. My circumstances dictated that I went through two foreclosures on the house I lived in, and without a crooked partner, I would have been able to cashout Lomty Investment. What Lomty did for me was to allow me the relief I needed to go on with my life and reestablish my financial world. They gave me the hope and relief to take myself forward into another successful situation.

I had contacted many banks. Although I have had absolutely flawless credit and have never beat anyone out of a cent, no financial institution would lend me money, secured or not. I could have owned my home free and clear and it would have not mattered. The system is set up for only those who do not need the money. Mine was a situation which transpired outside my control. This does not mean I was a bad person or a bad credit risk, it simply meant I did not fall inside the strict and stringent guidelines of the system. The high cost mortgage lender filled the need that no one else could.

I feel that eliminating this method of borrowing money is a most serious situation. There is a huge need which is being filled outside the awful guidelines of the banks. Please give the people like myself at least access to other means of credit and borrowing. Without it, many lives will be ruined financially.

Thank you for your considerations.

Yours very truly,

Donald T. Leabo

Donald T. Leabo

We need more investment companys like Security. People that will loan money when banks and other lenders won't.

Allow me to tell you how I learned about Security. My family and I were living in an apartment wondering if we would ever be able to buy a home with our income and our middle of the road credit history. (we didn't have bad credit but we didn't have great credit either).

Then we learned of a house that was being forclosed on. We could have the house for 60,000, even though it was worth 120,000 we had to close the deal in three weeks. Security was the only company that would loan us the money.

They didn't just say here's the deal take it or leave it. They sat down with us and helped us decide how long we would need before our credit could get the going rate. We decided eighteen months but we could extend that time if we need to.

Then we chose what we thought would be a comfortable monthly payment.

they worked around what we thought we needed. They were pleasant and worked with us not against. They gave us a chance when we needed it and time, consideration, and help. without them we wouldn't have gotten the house.

And sure you pay for these services But it gives people another option if they need it. And to those people who need it the price is worth it.

But this proposed legislation would put businesses like Country out of business. Then there gives one less option for people who need it. So just think about what you're doing.

Daniel & Nedra
[illegible]

Lloyd Thola Construction, Inc.
19606 Highway 410
Bonney Lake, Wa 98390
(206) 862-5977 fax: (206) 862-5978

January 20, 1994

Roger J. O'Connell
Lornty Investment Company
214 5th Ave S.
Seattle, WA

Dear Roger:

I just want to thank you for the loan you made to me. Without your help I would not have been able to improve my credit and ultimately get into business for myself. My business has grown from 21 sales in 1992, 43 sales in 1993 and 29 pending to date in 1994. The 1994 year should well exceed 75 homes. This is due in part to your financing help in the beginning.

It seems a shame that some legislation might prohibit you from making similar loans to others that you made to me. I didn't like your rate or fee but the bottom line is that you made the loan to me when no one else would. Again, a big part of my success is due to lenders like yourself willing to take a huge risk on people like me.

If I can help in anyway let me know.

Sincerely,

Lloyd A. Thola

Lloyd A. Thola
Thola Construction, Inc.

Gary T. Williams
1075 Bellevue Way
Suite 212
Bellevue, Wa 98004

24 January 1994

Lornty Investment Co.
Mr. Rodger O'Connell
214 5th Ave South
Seattle, WA 98114

Re: High Cost Mortgages
Senate Bill #924

Dear Rodger,

I am writing this letter to express my concern over Senate Bill No.924, which would restrict or limit the kind of lending that has personally helped me in the past.

When needing to borrow money without delay and unnecessary scrutinizing, I choose Lorenty Investment Co. I found your company accommodating and professional so much so, I've used your company a second time.

I support your efforts to defeat Senate Bill No.924, and to continue this type of lending.

Sincerely,

Gary T. Williams

Valerie T. Morse
Vice President
Government Relations
[illegible] FAX

Beneficial®

Beneficial Management
Corporation of America
[illegible] New Jersey Avenue - Southeast
Washington, DC [illegible]

March 21, 1994

The Honorable Joseph P. Kennedy, II
U.S. House of Representatives
1210 Longworth House Office Building
Washington, DC 20510

Dear Chairman Kennedy:

Thank you for your letter outlining revisions to HR 3153 which you intend to support as part of a Manager's amendment. Based on the revisions outlined, we are pleased to lend our support to your efforts in moving this legislation forward.

Abusive lending practices should be prevented and we are pleased to work with you toward that goal. One way to avoid abusive lending is to require borrowers to have some demonstrated means by which to repay a loan. The two-tiered debt-to-income trigger accomplishes this affordability test.

We appreciate your understanding of this issue.

Sincerely,

Valerie

Valerie T. Morse

VTM:kmm

HOUSEHOLD INTERNATIONAL

J Denis O'Toole

March 21, 1994

The Honorable Joseph P. Kennedy II
Chairman, Subcommittee on Consumer Credit and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
604 O'Neill House Office Building
Washington, DC 20515

Dear Mr. Chairman:

Thank you for your letter inviting Household International to testify before the Subcommittee on Consumer Credit and Insurance on HR 3153, the Home Equity Protection Act. We would also like to thank you for giving us the opportunity to work with you on this legislation and for being so responsive to our concerns.

Over a year ago, your Subcommittee held its first hearings on the subject of reverse redlining and specific types of abusive credit practices. Heartbreaking testimony was heard about the results of credit practices of certain second-mortgage lenders and third-party originators who targeted poor end working class consumers and who charged above market interest rates and/or add-on loan fees. There is no defense for these practices. We strongly believe, however, that these unconscionable practices are not standard business for our Company nor the many other lenders with whom we compete.

However, the practices of a few lenders caused harm to real individuals and, as legislators who recognize society's commitment to equal housing and credit opportunities, you were compelled to move in the direction of additional federal regulation of the home equity loan market. We support the direction in which you are moving in the manager's amendment described in your letter of March 17. We note, however, that HR 3153 as introduced was not tightly focused and actually went so far that the customers you seek to protect would have been harmed. We ask you to keep your bill tightly focused as proposed in your manager's amendment, and if this amendment is adopted as you have outlined, HFC will support its enactment by the House of Representatives.

The Honorable Joseph P. Kennedy II
Page Two

Household will be pleased to continue to work with the members of the Subcommittee to achieve a bi-partisan manager's amendment and we welcome the opportunity to work with you and community groups to close forever the sorry experience of reverse redlining.

Sincerely yours,

J. Denis O'Toole

J. Denis O'Toole

JDOT/JSA

AARP

Bringing lifetimes of experience and leadership to serve all generations.

March 21, 1994

The Honorable Joseph P. Kennedy, II
Chairman, Subcommittee on Consumer Credit and Insurance
604 O'Neill House Office Building
Washington, DC 20515

Dear Mr. Chairman:

I am writing to express the support of the American Association of Retired Persons (AARP) for the H.R. 3153 Home Equity Protection Act, which we understand that you will amend to to include provisions to protect consumers of reverse mortgages. This change is vital to the the continued provision of reverse mortgage opportunities to older homeowners who are "house-rich, but cash-poor" and have few other options for credit with reasonable terms.

An older person's home is a source of economic security as well as emotional comfort. For most older homeowners, home equity is the largest, if not the only, significant asset. Legitimate home equity loans as well as home equity conversion loans can be very useful financial instruments for older people who confront expenses that they cannot meet through income and other savings.

Unfortunately, unscrupulous home equity scam operators have preyed on vulnerable older persons -- especially in minority communities -- to steal the equity in their homes through exorbitant interest rates and fees. These loans are made without the usual regard for the ability to repay the loan and frequently result in foreclosure. Faced with debt they cannot pay, many older persons lose both their homes and their life savings.

The provisions of the Home Equity Protection Act will limit the tools used by home equity scam artists to steal equity from vulnerable homeowners. The prohibited practices as well as the disclosure requirements for high cost loans should greatly curtail the ability of scam artists to skirt the edges of the law without inhibiting legitimate business practices.

AARP would also like to express appreciation to you for working with consumer and industry groups to create an exemption from the high cost loan provisions for reverse mortgages. Because of the structure of reverse mortgages, they tend to have relatively high upfront costs which could run afoul of those provisions. We understand that you will seek to add language to exempt reverse mortgages from the act and create new, more appropriate disclosure requirements for reverse mortgages patterned after those now used under the FHA home equity conversion insurance demonstration. These requirements would promote important market innovations while providing consumers with the kind of information needed

American Association of Retired Persons 601 E Street, N.W. Washington, D.C. 20049 (202) 434-2277

Lovola W. Burgess *President* Horace B. Deets *Executive Director*

The Honorable Joseph P. Kennedy, II
March 21, 1994
page 2

to make meaningful comparisons among very different types of reverse mortgages. All reverse mortgages -- whether or not they are linked to annuities or whether or not they charge a percentage of the home's appreciation -- could be compared by a table of annual interest rates which will reflect all costs and benefits. Only in this way can consumers make informed choices among products to fit their needs and resources.

The Association commends your leadership in crafting this important legislation to curtail abusive lending practices and provide affirmative guidance to promising innovations in the reverse mortgage industry. If we can be of further assistance on this or other matters, please do not hesitate to contact Don Redfoot of our Federal Affairs staff at 434-3800.

Sincerely,

Martin Corry, Director
Federal Affairs

Fleet Finance, Inc.

John S. Poelker
Chairman and Chief Executive Officer

Faxed to 202-225-7960

March 21, 1994

The Honorable Joseph P. Kennedy
Chairman, Subcommittee on Consumer
Credit and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives
Room 604, O'Neill House Office Building
Washington, D.C. 20515

Re: H.R. 3153

Dear Chairman Kennedy:

On behalf of Fleet Finance, a $2.6 billion consumer and mortgage lending subsidiary of Fleet Financial Group, Inc. headquartered in Atlanta, Georgia, I would like to thank you for giving us the opportunity to submit comments on your legislation, the "Home Equity Protection Act", H.R. 3153.

Fleet Finance strongly supports clear and effective disclosures to assure that consumers are fully informed about credit transactions. Although we had a number of major concerns about H.R. 3153 as introduced, we are greatly encouraged by the revisions that we understand you intend to make through a Manager's Amendment when this bill is marked-up by your Subcommittee. With the adoption of these proposed amendments, and the resolution of a few technical issues on which we hope to continue to work with you, we believe that H.R. 3153 is a constructive piece of legislation that will protect both consumers and lenders against potentially abusive practices in the second mortgage industry and should be enacted into law.

There is also a great deal that the private sector can do to help, and Fleet Finance and the entire Fleet organization has embarked on an aggressive effort to expand its consumer service and education programs. For instance, last year Fleet Finance developed a new program, in conjunction with the National Consumers League, to provide consumers with straightforward information about credit. With the League's help, we are conducting workshops first in Georgia

Fleet Finance, Inc. Suite 800, 211 Perimeter Center Parkway, Atlanta, Georgia 30346-1305 404-392-2427
A Member of Fleet Financial Group, Inc.

March 21, 1994
Honorable Joseph P. Kennedy
Page Two

and Florida, and later in all states in which Fleet Finance conducts business, where consumers learn about credit histories, mortgage hoans, how to work with lenders, and issues that affect family budgets and accessing credit. In addition, Fleet Financial Group is initiating consumer education programs through the Fleet INCITY program.

Mr. Chairman, we congratulate you for sponsoring this legislation, and look forward to working with you as H.R. 3153 is given further consideration by the House Banking Committee and the Congress in the weeks ahead.

Sincerely,

John S. Poelker

JSP/Mr (hopejep3.21)

ISBN 0-16-046631-8
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